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The Political Economy of Progressive Tax Reform in Chile[1]

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The top 1 percent of adults in Chile earns 22 percent of national income,[2] but the taxes they pay are modest. The corporate income tax rate is presently 20 percent, and the top 1 percent pays an effective average income tax rate of less than 16 percent (Fairfield and Jorratt 2014). But that situation may soon change. During the 2013 campaign, then-candidate and now President Michele Bachelet proposed a major tax reform intended to raise 3 percent of GDP to finance public education, following the major wave of student protests in 2011 and 2012. The proposal represents a dramatic break with Chile's experience of at most modest and usually marginal income tax reform over the past two decades. This paper provides a salient background analysis of why increasing income taxes proved so difficult under previous center-left administrations, and how those governments managed to pass incremental reforms despite the obstacles they faced, in order to place Chile's current debate on tax reform in perspective and to shed light on the new administration's prospects for enacting its reform proposal.

Major political obstacles hindered progressive tax reform during the two decades following Chile's return to democracy in 1990. Strong actors defended the core interests of economic elites: organized business and parties on the political right (the Unión Demócratica Independiente, UDI, and to a lesser extent the Renovación Nacional, RN) consistently defended the low-tax, neoliberal model originally implemented by the dictatorship of General Augusto Pinochet.

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[1] Parts of the analysis in this paper draw on Fairfield 2010, "Business Power and Tax Reform: Taxing Income and Profits in Chile and Argentina," *Latin American Politics and Society* 52 (2): 37-71, and Fairfield 2013, "Going Where the Money Is: Strategies for Taxing Economic Elites in Unequal Democracies," *World Development* 47: 42-57. More extensive analysis of tax reform in Chile appears in the author's book manuscript, *Private Wealth and Public Revenue*. Field research was supported by the Social Science Research Council and the International Center for Tax and Development. I thank Stephen Kaplan for helpful comments at the December 2012 Wilson Center workshop on the Political Economy of Tax Reform in Latin America.
[2] This estimate is adjusted for underreported income (Fairfield and Jorratt 2014).

Organized business was a key actor not only in corporate tax politics but also in individual income tax politics, since the primary inequity in Chile's income tax system is the preferential treatment of capital income (or income that can be disguised as capital income) compared to wage income. Business had a strong capacity to influence policy decisions due to its influential cross-sectoral peak association, the CPC (Confederación de la Producción y el Comercio), and ties to political parties on the right, especially the UDI. The CPC is one of Latin America's strongest encompassing associations (Schneider 2005); it helped build consensus across sectors and coordinated lobbying on issues of common interest to business, like taxation. The ability to present a united front strengthened business's bargaining position; CPC demands could not be dismissed by policymakers as narrow, illegitimate sectoral interests. Business's bargaining position was further enhanced by its capacity to form a united front with right parties against tax increases.

Chile's two right parties have very different origins, but both have strongly defended Pinochet's economic model. During the past two decades, they tended to vote against tax increases, as well as minimum wage increases and other regulatory and/or redistributive reforms that represented a move toward greater state

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involvement in the economy (Luna 2010). The UDI in particular has had strong ties to business that originated during the dictatorship. Former members of the Pinochet government who became UDI politicians also became board members of privatized enterprises (Silva 1996, Schamis 1999). Available evidence suggests that business generously funded the UDI, which reciprocated in what can be termed a "core constituency" relationship (Gibson 1996) by representing business interests in congress on economic policy issues. The right parties draw electoral support from high-income voters more generally through programmatic linkages, among which a key policy position is low taxation (Luna 2006). The parties on the right had significant capacity to influence policy due to strong representation in the senate. Thanks to electoral rules that favored the right and the presence of right-leaning unelected senators designated by Pinochet during the 1990 transition to democracy, the right controlled enough seats to veto legislation during the 1990s. During the 2000s, the right's veto power eroded, since the center-left Concertación coalition, which governed from 1990 to 2010, was able to replace several of Pinochet's designated senators with its own members. Nevertheless, the right and the left remained nearly tied in the Senate throughout the decade.

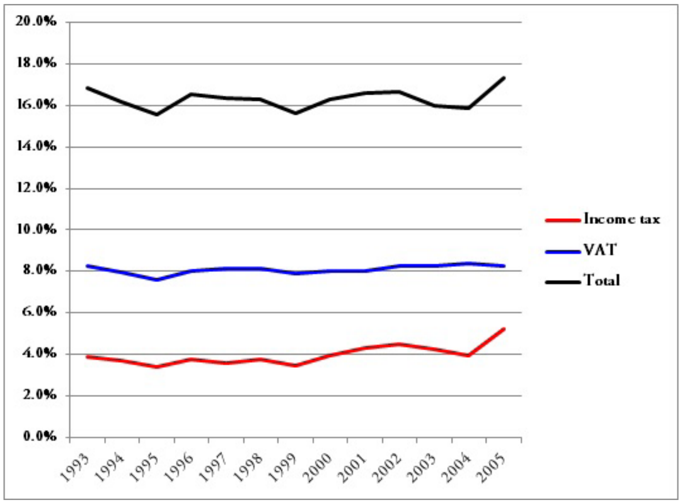
Business-right opposition made legislating any tax increases, let alone making the tax system more progressive, a difficult political battle for Concertación governments. The anticipation of coordinated business-right opposition deterred governments from proposing significant tax increases that high-level officials otherwise viewed as appropriate and desirable (Fairfield 2010). However, Concertación governments used a number of strategies that in conjunction with opportune timing helped to make marginal tax increases politically feasible. While these tax increases did not add up to significant change, they did help governments secure funding for social spending, and they contributed to incremental progress toward a more progressive tax system.

The body of the paper proceeds as follows: Section I provides a brief overview of Chile's tax system and identifies the main factors that have led to under-taxation of highly-concentrated income and profits; Section II explains the institutional context and the tax policymaking process in Chile following democratization; Section III discusses the strategies that Chilean governments have used to implement incremental tax increases; and Section IV examines cases in which they were applied with varying degrees of success. The paper concludes by returning to the current debate on income tax reform in Chile.

The Chilean Tax System

Like most other Latin American countries, Chile relies heavily on indirect taxes (Figure 1). The revenues raised by the VAT equaled an average of 8.1 percent GDP over 1993-2005, constituting approximately 51 percent of total tax revenue. Meanwhile, the income tax generated an average of 4.0 percent of GDP. While Chile's overall tax revenue is not low by Latin American standards, Chilean governments have faced periodic revenue needs (with the exception of 2006-2009, when surging copper prices exogenously produced higher tax revenue). Given that the VAT base is already quite broad and the rate is relatively high (18 percent from 1990-2003 and 19 percent thereafter), increasing the income taxes paid by upper-income individuals and big businesses has been an obvious option for further increasing tax revenue.

Figure 1. Tax Revenue in Chile, 1993-2005



Source: Serie Ingresos Tributarios, SII

Understanding the unique characteristics of Chile's income tax system is imperative for comprehending the nature of under-taxation of income and profits in Chile and the parameters of the tax reform problem. Chile has an "integrated" income tax system that ties together the corporate tax and the individual income tax. Businesses pay corporate tax on their accrued profits. This corporate tax functions as a withholding against business-owners' individual taxes. When a business distributes profits to its owners, those earnings enter into the owners' taxable income base, but the owners receive a credit for the corresponding corporate tax that the company already paid. This mechanism ensures that capital income is not "double-taxed."

The individual income tax rates for wealthy Chileans are much higher than the corporate tax rate. The top marginal income tax rate is 40 percent, while the corporate tax is currently only 20 percent (as of 2013), one of the lowest in Latin America. This large gap in tax rates was intended to create incentives for businesses to reinvest their profits and thereby contribute to economic growth and development. However, the income tax system has a problematic, unintended consequence: it facilitates tax avoidance and evasion. Owners of businesses organized as partnerships, which are much more common than publicly-traded corporations, find multiple ways to consume business profits without declaring those profits as individual income (which would be subject to the much higher individual income tax rates). For example, a recreational vehicle for personal use might be registered to the firm rather than the owner, or the owner might simply omit distributed profits on his or her individual income tax declaration. It is very difficult for the tax agency to detect this type of evasion for lack of information on earnings from a disinterested third party. In addition, independent professionals regularly "incorporate" in order to transform earnings that would otherwise pay high individual income tax rates into corporate income subject to the much lower tax rate. Wage earners are the only taxpayers who cannot manipulate the income tax system to their advantage—their income taxes are automatically withheld by employers.

Ultimately, the large gap between the corporate and individual income tax rates does little to stimulate productive investment (Jorratt 2009: 58), and it is a source of substantial tax expenditure. Jorratt calculates that that deferred taxation of business profits cost the state 0.9 percent of GDP in potential tax revenue in 2003 (SII 2004). Because capital income is highly concentrated in Chile, this special treatment of capital income also erodes the progressivity of the income tax.

Numerous additional special treatments and privileges for capital income, including low tax rates and exemptions for capital gains, further erode the revenue capacity and progressivity of the income tax. Total tax expenditures in the income tax have fluctuated between 3.1 percent and 4.4 percent of GPD from 2003 to 2008 (Jorratt 2012).

This discussion illustrates that increasing the corporate tax rate and eliminating other tax privileges for capital income are critical for increasing the revenue capacity and progressivity of the Chilean income tax system. The cases examined in Section IV are examples of such measures.

The Tax Reform Policy Process

Chile's stable institutional environment, along with its comparatively stable party system and highly-organized and cohesive business sector, contributed to a consistent pattern of tax policymaking from 1990-2010 under Concertación governments. The constitution grants the Chilean executive exclusive initiative on tax policy. Executive-branch authorities in the Finance Ministry drafted reform initiatives, often consulting with legislators and leaders of business associations in order to assess the political feasibility of proposed tax policy changes. When the executive branch ascertained that a reform option would not enjoy sufficient support in congress or would stimulate strong opposition from organized business, that option would be discarded. The anticipation of a veto by the right and Pinochet's appointed senators in congress helped remove multiple income tax initiatives from the agenda during the 1990s. Governments also had incentives to avoid provoking conflict with business on taxation—a core concern for the largely Pinochet-aligned private sector—in the period following the transition to democracy. A pattern of informally institutionalized consultation with business associations on all matters of economic policymaking (Silva 1997) reinforced these incentives to avoid conflict with business in areas affecting its core interests, so as not to disrupt productive cooperation on other issues (Fairfield 2010).

If the executive branch ascertained that a tax reform initiative had real prospects for enactment, a bill would be sent to congress. The lower house would consider the reform first, followed by the senate. Given that the center-right enjoyed greater representation in the Senate than in the lower house, thanks in part to electoral rules that are generally understood to favor the right, the most significant modifications to reform bills tended to arise from negotiations in the upper house. Although legislators can only vote to accept or reject measures in a tax-reform bill—they cannot modify the text of a tax bill due to exclusive executive initiative—the executive regularly negotiated modifications to placate the right (and occasionally to maintain discipline within the governing coalition). Modifications were often necessary to ensure sufficient votes to pass legislation. In addition, Concertación governments tended to prefer securing at least some opposition votes in order to enhance the legitimacy and longevity of reforms; this style of policymaking rose out of the experience of key Concertación leaders during the 1973 coup and the subsequent dictatorship. For similar reasons, governments tended to under-utilize strong constitutional executive powers (Siavelis 2002). Moreover, using veto powers constituted a "nuclear option" (Navia 2012) that could seriously undermine the executive's ability to negotiate reforms with the opposition in the future.[3]

The Concertación's Strategy Repertoire

The Concertación developed a repertoire of what I term "tax-side strategies" and "benefit-side strategies" to manage strong opposition to tax increases from the business community and the right (Fairfield 2013).[4] The former, which include attenuating impact and legitimating appeals, apply design-based and/or framing techniques. The latter, which include emphasizing fiscal discipline, compensation, and linking to social spending, aim to focus attention on the benefits that taxation will fund. These strategies are designed to mobilize popular support for reform and/or to temper elite antagonism toward reform. Several of these strategies also served to consolidate support within the governing coalition itself; divisions between the more liberal wing of the coalition and its more statist, left-leaning wing occasionally threatened discipline on tax issues. Several of these reform strategies were employed in Chile as early as 1964 under the reformist government of Christian Democrat Frei Montalva (Ascher 1984: 128-131). Below I provide an overview of these strategies and explain the factors underpinning their potential for success as well as factors that occasionally limited the effectiveness of these strategies in the Chilean context. Some strategies have become less effective (if not less frequently employed) over time, while others have become increasingly potent due to the changing nature of electoral competition with the right. In general, the Concertación made use of multiple reform strategies when advancing any particular tax increase.

Attenuating Impact

This strategy involves gradualism, with the goal of minimizing opposition to reform by limiting its impact. Rather than attempting comprehensive reform, Concertación administrations pursued incremental reforms, gradually increasing tax rates and broadening tax bases when feasible, in accord with President Aylwin's dictum from the early 1990s that reform should be undertaken "*en la medida de lo posible*." [5]

Concertación administrations have used two reform design techniques to attenuate impact: phase-ins and "temporary" reforms. Phase-ins entail gradual implementation. For example, a tax-rate increase can be implemented in small increments over an interval of several years, or a base-broadening measure could be scheduled to take effect several years after its approval in Congress. Phase-ins give the business community a transition time to adjust their investment plans to tax increases or to finish projects that were already underway before the tax rules change. Consequently, phase-ins help to reduce business opposition and can neutralize concerns regarding a tax increase's potential impact on investment.

The second technique involves legislating a tax increase for a limited period of time, after which the pre-reform tax legislation will go back into

[3] See Flores (2010) on incentives for cooperation created by Chile's party system.
[4] See Fairfield (2013) for a more general theoretical treatment of these tax reform strategies, with applications to additional Latin American country cases.

[5] Aylwin used this phrase with reference to his circumscribed pursuit of justice for military officials following the transition to democracy. *El País*, January 2, 1991: "Aylwin reitera que investigará a fondo la violación de los derechos humanos en Chile."

affect. Variants of this technique, to which Ascher (1984: 131) refers as a "foot in the door" strategy, were employed by President Frei Montalva in the 1960s. This technique was also used in Chile's well-known 1990 tax reform: initially designing the corporate tax increase as temporary helped to get the initiative past business and the right, and the Concertación was later able to make the tax increase permanent. In fact, every time a government legislated a temporary tax increase, the reform was later renewed or made permanent. Renegotiating reforms that have already been in effect for several years is often easier than passing the reform for the first time; governments have been able to argue convincingly that the tax increase in question did not hurt investment, and they have argued that an abrupt loss of revenue would threaten fiscal discipline (see emphasizing fiscal discipline below).

While techniques that attenuate impact helped the Concertación extract more revenue from economic elites, business and the right became quite aware of this strategy over time and therefore tended to resist even marginal tax increases, based on the argument that the cumulative affects are non-trivial. A former General Manager of the CPC (b 2007, interview) explained the business sector's resistance to even minor tax increases as follows: "What happened with many Concertación governments is that if you analyze a given law, or part of a law, on its own it does not have a big impact, but if you add up one law here and another six months later, and another and another, in the end, of course it has an impact." Likewise, marketing reforms as "temporary" became less effective over time, given that business and the right came to anticipate that the Concertación would try to make all such reforms permanent in the future—in essence, promises that tax increases would be temporary lost credibility. Accordingly, these actors sough to prevent reforms from passing in the first place.

Legitimating Appeals

Legitimating appeals aim to mobilize public support by drawing on widely espoused norms like equity, thereby pressuring politicians to accept reforms they might otherwise oppose. In Chile, Concertación governments deployed such appeals in an effort to draw the right's attention away from the interests of its core business constituency to focus instead on the broader electorate and potential electoral costs to opposing tax increases.

Concertación governments applied two main types of legitimating appeals. The first type, vertical equity appeals, draws on the principle that taxation should be progressive. Equity appeals work best in conjunction with progressive reforms that clearly target economic elites rather than affecting middle or lower-income sectors as well. As in other countries, business and the right in Chile regularly sought to frame tax increases as affecting small businesses or the middle class—usually professionals who although dramatically better-off than the average citizen are not members of the truly wealthy elite. This argument is harder to make when tax increases narrowly and patently affect the wealthiest taxpayers.

Vertical equity appeals in Chile served not only to put business and the right on the defensive, but also to align Concertación legislators behind executive tax proposals. On the one hand, targeting tax increases at upper-income sectors helped to secure support from more conservative Christian Democrats within the governing coalition, who were particularly vulnerable to the strategy by organized business and the right of framing tax increases as harmful to the middle class. During the 2000s, the Christian Democratic party competed with the UDI to represent "middle class" sectors (Navarette 2005: 129, Huneeus 2003: 122). Consequently, campaigns denouncing tax increases as burdening small and medium businesses or working professionals could be quite effective for defeating tax reforms. The possibility that Christian Democrats and other legislators from the conservative wing of the Concertación might side with business and the right against the executive's tax proposals was a frequent concern for Finance Ministry technocrats. On the other hand, vertical equity appeals helped secure support from the left wing of the Concertación, which frequently complained that government policies were not sufficiently progressive and redistributive. To this end, the executive tried to use vertical equity appeals to promote even tax increases that strictly speaking were regressive, such as the 2003 VAT increase.[6]

The second type of legitimating appeal draws on the principle of horizontal equity—individuals or firms earning similar incomes should pay similar taxes, even if the sources of their income are different. Eliminating sectoral tax incentives and broadening the income tax base to include exempt forms of capital income are examples of reforms that enhance horizontal equity. Cutting down on tax evasion also improves horizontal equity. Horizontal equity appeals can not only mobilize public support, but may even generate actual support from within the ranks of economic elites. For example, law-abiding firms tend to support reforms designed to control corporate tax evasion. In Chile, business support for anti-evasion reforms varied depending on the measures proposed; for example, business accepted higher fines for tax evasion but strongly opposed granting the tax agency greater auditing powers. In theory, eliminating sectoral tax benefits can also generate support from business sectors that do not enjoy those benefits. In Chile, however, reforms to eliminate sector-specific tax benefits generated at most tacit approval within the business sector, given strong business cohesion and solidarity in opposition to tax increases. In several cases, the business community banded together to actively oppose reforms that sought to raise revenue from under-taxed sectors—most notably the mining sector.

In general, legitimating appeals work best when political competition is strong, and when major elections are approaching. Under these conditions, politicians tend to be most attuned to public opinion. However, research on political parties and representation has shown that multiple factors can break the logic of democratic accountability, such that politicians may escape electoral punishment even if their policy positions diverge from public opinion (see for example Hacker and Pierson 2005, 2010). In Chile, the nature of the UDI's linkages to its electorate buffered the effect of legitimating appeals. While the party attracts support from economic elites based on its economic policy positions, including low taxation, the party wins votes from low-income sectors through personalistic appeals and small-scale clientelism (Luna 2010). The UDI therefore has had leeway to maintain mass electoral support despite policy positions against redistribution.

Stressing Fiscal Discipline

Emphasizing fiscal discipline with the goal of minimizing business-right opposition to reform was a consistent feature of tax politics in Chile from 1990 to 2010. During the transition to democracy, organized business and the right were concerned that the Concertación would engage in irresponsible spending, which was deemed a major cause of the economic problems of the Allende period, including hyperinflation. Pointing out that higher tax revenue was essential

[6] These appeals cited the fact that the bulk of tax revenue from the VAT originates from upper-income groups, given Chile's extreme inequality.

for maintaining fiscal discipline – given increased demands on government resources in the context of democratization – was critical for passing the 1990 tax reform and making the corporate tax increase permanent in 1993 (Boylan 1996, Marcel 1997). After 2005, however, emphasizing fiscal discipline became a less effective strategy due to the context of record fiscal surpluses associated with high copper prices. Copper revenue entered state coffers both through the state-owned mining company CODELCO and through taxation of the booming privately-owned copper sector. Even governing-coalition politicians questioned the need to increase taxes to support new government expenditures in this context.

The Concertación almost always coupled emphasis on fiscal discipline with either linking to social spending or elite compensation. In fact, linking tax increases to social spending requires either tacitly or explicitly making the case that expanded spending is acceptable only if new resources can be generated to finance it. The same observation holds in the case of compensations for elites that entail fiscal cost, such as reducing other taxes.

Linking to Social Spending

Linking to popular benefits like social spending is a strategy for mobilizing public support and pressuring politicians to accept tax increases. Linking strategies help policy entrepreneurs place blame on legislators who vote against reform and can also create positive incentives for politicians to support reform by letting them share credit for providing popular benefits.

Linking tax increases to social spending has a long history in Chile and has been one of the most widely employed reform strategies following the transition to democracy. President Frei Montalva frequently employed this strategy in the 1960s (Ascher 1984: 129-130). Linking to spending played a key role in forging support for the 1990 tax reform (Boylan 1996) and was employed in every tax increase since 1990, with only two exceptions.[7] Informants from the Lagos administration and prior Concertación administrations consistently expressed the view that tax increases were feasible only when the executive could argue that a particular program(s) required funding (2005 interviews: Finance Ministry A, Marcel, Marfán, Finance Ministry B). According to Former President Lagos (2006, interview), "The key to a tax reform is to link it to the destination of the funds. I never wanted to discuss the tax reform, I discussed what I was going to do with the money." Similarly, a Finance Ministry informant from the Aywlin and Frei administrations maintained, "You debate the public policies and the financing in the same package. They form parts of a whole, they are not separate things… That is a very key element" (Marfán 2005, interview).

The Concertación used three techniques for linking tax increases to spending. In some cases, links were based mostly on discourse—proposal texts and government officials explained that the tax increase was needed to fund expanded social spending. A second, stronger linking technique entailed formally including new spending programs with tax increases in the same legislative proposal, forcing both aspects to be debated at the same time and making the links more apparent as described above by Marfán. Even tighter links could be created by making spending initiatives contingent on approval of the tax increase. This third technique was possible because the executive branch in Chile has the privilege of exclusive initiative on tax reforms—as noted previously,

[7] These exceptions were the 2001 corporate tax increase, which was revenue-neutral due to an accompanying income tax rate cut, and the 2005 mining tax, which enjoyed strong inherent popularity and legitimacy based on nationalist sentiments.

only the executive can propose or amend a tax bill; while legislators can approve or reject measures in a tax bill, they cannot change the wording or the content of an article. Consequently, the executive could phrase a proposal such that if the tax increase were rejected, the spending program to be funded would not take effect. In the absence of exclusive initiative, contingency would not be possible; legislators could simply introduce their own modifications to the proposal and pass the spending measures but not the tax increases. Contingency allows for the tightest possible linking to social spending or popular benefits in Chile, since earmarking is prohibited by the constitution.

Linking to social spending could be an effective strategy for reducing opposition from the right for two reasons. First, there tended to be more consensus between the left and the right in Chile on social spending than on taxation. The Pinochet regime pioneered targeted spending during the dictatorship, partly to generate a base of popular support (Etchemendy 2004: 304-310, 314-315), and the Concertación subsequently adopted and expanded that model (Castiglioni 2005). Second, right-party legislators can feel electoral pressure to support popular programs. Especially in cases where the spending program is popularly viewed as – or can easily be framed as – highly justified on the basis of equity or morality, like increasing pensions for the elderly poor, opposing a tax increase linked to spending can be politically damaging. For example, an UDI deputy commented, "Yes, it has an impact – the government's capacity to say 'no, those people do not want to improve the social projects and will not give money for that,'…it hurts us, the story that the government manages to tell" (UDI.b 2005, interview).

Business was also sensitive to the possibility that rejecting tax increases designed to fund social spending could damage its public image and foment demands for more extensive redistribution. Several business informants acknowledged that linking to spending made it more difficult to oppose tax increases (interviews: CPC.a 2005, CPC.b 2007). However, business and the right had no shortage of arguments with which to defend their opposition to tax increases even when linked to social spending. For example, business and the right increasingly maintained that social spending should be funded through improved efficiency, reallocation, privatization, or simply economic growth.

Compensation

By compensation, I refer to strategies that provide benefits for the elite taxpayers who will bear the burden of tax increases, as distinct from strategies that link tax increases affecting upper-income sectors to benefits for popular sectors which are not subject to the tax increase. Compensation can take many different forms, from implementing other reforms that economic elites want, to cutting taxes other than those selected for increases. In Chile, Concertación governments often created alternative investment incentives to replace tax benefits targeted for elimination or simultaneously reduced "inefficient" taxes that business opposed. Governments sometimes compensated business with tax stability agreements. In 1993, the government was able to make the 1990 corporate tax increase permanent in exchange for cutting top personal income tax rates and an informal agreement not to increase direct taxes for the next four years. And the government offered mining companies benefits in the form of extended tax invariability clauses to mitigate opposition to the new mining tax legislated in 2005.[8]

Generally speaking, significant compensations were necessary to reduce opposition to progressive

[8] A similar technique was used when the Piñera government increased the mining tax to help finance reconstruction following the massive 2010 earthquake.

tax increases, given the strength of business and the right, which defended the economic interests of upper-income sectors. In contrast, Argentine governments were able legislate more substantial tax increases in exchange for less expensive compensations, given the organizational weakness and fragmentation of Argentina's business sector and the absence of a party with strong ties to economic elites in congress (Fairfield 2013b).

Case Studies

This section discusses three case studies from the Lagos administration (2001-2005): the 2001 Anti-Evasion Reform, the 2001 corporate tax increase, and the 2005 elimination of article *57 bis.*, a tax subsidy for certain stock owners. These reforms were the most important initiatives to increase income tax revenue and/or equity after the 1990 tax reform, which increased the corporate tax rate from 10 percent to 15 percent. Equity appeals effectively minimized opposition from the right in the 2005 reform, given the high salience of inequality during the presidential campaign. By contrast, multiple strategies proved marginally effective in the 2001 reforms. The section ends with a brief analysis of income tax developments during the center-right Piñera administration's (2010-2013) first year in office.

Anti-Evasion Reform

Equity appeals and strategic reform design helped the Lagos administration legislate the 2001 Anti-Evasion reform during a period of economic recession and strong contestation from business and the right (Silva 2002). For political expediency, the government tried to raise revenue mostly with measures to fight indirect tax evasion. However, the Finance Ministry also proposed restricting some income tax benefits that facilitated tax avoidance. These income tax base-broadening measures were very modest in terms of revenue yield, yet they were highly controversial. While equity appeals did not prevent difficult confrontations with business and the right, these strategies were nevertheless critical for legislating the reform.

The government used vertical and horizontal equity appeals in an effort to contain business-right opposition. For example President Lagos invoked vertical equity at a public meeting in September 2000 when he decried that it was not fair for Chileans of modest means to pay 18 percent VAT on their purchases while those with more resources used loopholes to avoid paying their income taxes. He added: "There are bad Chileans who don't pay all their taxes. For that reason, I sent a proposal to the legislature aimed at ending tax evasion, so that all would pay their fair share in contributing to Chile's progress."[9] Meanwhile, the proposal text appealed to horizontal equity as follows: "Tax evasion represents a situation of great inequity, between those who fulfill their tax obligations and those who do not. Correcting this inequity is not only an ethical imperative; it is also indispensable to the proper functioning of a modern economy….The fact that some companies fulfill their tax obligations creates a situation of disloyal competition vis-à-vis the rest of the private sector."[10] The government applied equity appeals to the income tax base-broadening measures as well, by characterizing the use of what business

[9] Original Spanish: "Hay malos chilenos que no pagan todos sus impuestos y por eso mandé un proyecto al Parlamento para que no haya evasión tributaria, para que todos paguemos lo que nos corresponde para contribuir a progreso de Chile." *El Mercurio*, September 10, 2000: "Lagos pidió apoyo al proyecto contra la evasión."

[10] Original Spanish: "La evasión de impuestos representa una situación de gran inequidad entre quienes cumplen sus obligaciones tributarias y quienes no lo hacen. Corregir esta inequidad no es sólo un imperativo ético, sino también un requisito indispensable para el buen funcionamiento de una economía moderna. … el cumplimiento de las obligaciones tributarias por parte de algunas empresas genera una situación de competencia desleal respecto del resto del sector privado." Mensaje de Proyecto 178-342, July 10, 2001.

and the right insisted were legal tax benefits as tax avoidance. Portraying the income tax measures as way to clamp down on morally inappropriate behavior, instead of just an alternative way to raise revenue, aimed to discredit and undermine business opposition. Executive-branch officials in fact publicly maintained that the reform did not include tax increases.[11] The Anti-Evasion reform was also loosely linked to social spending, but that strategy played a secondary role given the strong moral legitimacy of curtailing evasion (interviews: Lagos 2007, Boeninger 2005).

Although the government had to negotiate important concessions to placate business and the right before the reform was approved, the equity appeals helped navigate the package through congress. Government informants asserted that the strategy put strong pressure on the right. The former Senate president asserted that the right found itself in an awkward position: "I definitely believe that they convinced themselves that their argument was not well-founded. [Interviewer: So in your opinion, the right was in a defensive position?] "That's it; absolutely defensive. Anything that had even the slightest whiff of a higher tax rate or levy, they opposed. They looked for whatever kind of argument.[12] Similarly, an eminent Concertación senator asserted: "For the opposition, it was never easy to be strongly against the reductions in tax evasion. That had a basic legitimacy, and was a very significant part of the package. *[Interviewer] But the right argued it was a disguised tax reform, was that effective?* No, and finally they had to concede that this was reasonable," (interview, Boeninger 2005). In fact, two right Senators explained to the press that they abstained instead of voting against the reform during its first hearing on the floor in anticipation of damaging government recriminations: "If we hadn't done so, President Lagos would have said that the opposition was opposed to combatting tax evasion."[13] Seven right senators abstained when the reform came to a vote on floor, thereby conceding tacit acceptance.

2001 Corporate Tax Increase

The 2001 corporate tax increase, an idea that took shape while the Anti-Evasion reform was under debate, was legislated with a different mix of strategies. Compensating economic elites in conjunction with emphasizing fiscal discipline were the central strategies in this case; equity appeals and phase-ins were employed as well.

The modest corporate tax increase from 15 percent to 17 percent was made feasible by simultaneously reducing personal income tax rates for individuals in the top income brackets—the bill proposed cutting the top marginal income tax rate from 45 percent to 40 percent, cutting the rate for the second-highest bracket from 35 percent to 32 percent, and creating an intermediate bracket with a rate of 37 percent. According to Finance Ministry calculations, this tax cut exactly (along with additional modifications described below) offset the revenue gains associated with the corporate tax increase, making the reform package revenue-neutral. However, the government anticipated that reducing the gap between the

[11] *El Mercurio*, October 8, 2000.

[12] Original Spanish: "creo en definitiva ellos mismos se convencieron que su argumento no tenía mucho fundamento. [Interviewer] Así que en su opinión ¿la derecha estaba en una posición defensiva? Nada más, absolutamente defensiva, y cualquier cosa que oliera a un mayor gravamen, a un mayor impuesto ellos estaban en contra—buscaban cualquier tipo de argumento [en contra]," Interview: PDC 2007

[13] Original Spanish: "caso contrario, el Presidente Lagos hubiese dicho que la oposición se opone a que se combata la evasión tributaria." Senators Prat and Matthei, in *El Mercurio*, March 15, 2001: "Avance trámite de evasión tributaria."

corporate and individual income tax rates would reduce incentives for individuals to incorporate or under-declare distributed profits, thereby leading to some revenue gain at the margins.

The individual income tax rate cut compensated economic elites for the corporate tax increase. Business owners and independent professionals who did not engage in the types of avoidance and evasion described in Section I would in fact receive a net income tax reduction, since the corporate tax is simply an advance payment on taxes owed when profits are distributed to owners. Business owners and independent professionals who did engage in individual income tax avoidance and evasion would experience a very modest income tax increase, yet any other sources of income they earned would be taxed at the reduced individual income tax rates.

While the individual income tax cuts contributed to reducing the gap with the corporate tax, which the Finance Ministry (A 2007, interview) viewed as a major problem, its most important function was to reduce resistance from business and the right to the corporate tax increase. Former President Lagos (interview 2006) described the tax cuts as a "candy" to placate these powerful actors. As anticipated, business associations endorsed the personal income tax cuts as a move in the correct direction (CPC 2001). Right politicians likewise condoned these measures, given their sympathy with business's view that taxation in Chile was already too high.[14] Meanwhile, the government asserted that the personal income tax cuts were untenable without the corporate tax increase, given the importance of maintaining fiscal discipline and sustaining social spending programs for poor Chileans.

Equity appeals entered the debate in a different way from the Anti-Evasion reform: the government, and especially key Christian Democratic legislators including Senator Foxley, portrayed the individual income tax reductions as a tax cut for the "middle class." The logic was that wage-earners, whose taxes are automatically withheld by employers, were the only taxpayers who could not find ways to avoid the high individual income tax rates, and in practice they therefore paid much higher effective tax rates than taxpayers with business income. The reform would therefore shift some of the effective tax burden from wage-earners to individual-income-tax-avoiding business owners. The net effect of the reform would thus be mildly progressive, given that accrued profits greatly predominated all other assets and income sources for taxpayers in the top brackets.

Of course, the few wage-earners who would benefit from the tax cuts hardly belonged to any notion of the "middle class" grounded in Chile's objective income distribution. These taxpayers in fact belonged to roughly the top 1 percent of adults (Agostini et al. 2013: 178). However, by comparison to Chile's far wealthier business magnates, these high-end wage earners fit with conceptualizations of the middle class employed by many Christian Democratic politicians seeking to court these constituencies, as well as right-coalition politicians and the taxpayers in question themselves. Such subjective notions of the middle class have had important implications for tax reform elsewhere in Latin America as well (Rius 2013).

The government appealed to the broader universe of income taxpayers—also construed as members of the "middle class"—by increasing the taxable income threshold and by introducing a limited tax credit for mortgage payments. These measures appealed to business as well. The CPC (2001)

[14] See for example Diario de Sesiones del Senado de Chile, Legislature 244, Sesión 18a, August 7, 2001.

endorsed the government's assertion that the mortgage tax credits would stimulate growth in the construction sector (Mensaje 96-344: 7).

In addition to compensating elites and framing the reform as enhancing vertical equity by reducing the burden on the middle class, the government gradually phased in the controversial corporate tax increase. The two-point increase was implemented in increments over a period of three years, such that the corporate tax rate would reach 17 percent only in the year 2004.

Negotiating the reform with the business community and the right proved difficult, despite the multiple strategies employed. Foxley (interview 2006) described the process as "*muy complejo con mucho conflicto*," ["very complex and with a lot of conflict"] and a prominent PDC Senator (interview 2007) described this mild corporate tax increase as the tax initiative that business and the right most strongly disliked during Lagos' administration. Most of the RN and several of the designated senators voted in favor of the reform package as a whole, given their approval of the personal income tax cuts, but the UDI abstained to register their objection to increasing the corporate tax. The UDI voted *en bloc* to eliminate the corporate tax increase during the subsequent line-item vote.

Counterfactual analysis suggests that prospects for legislating the corporate tax increase would have been far worse had the personal income tax cuts been omitted from the reform—it is clear from transcripts of the senate debate that this compensation was critical for garnering support from among the ranks of the right coalition and the designated senators. RN senators who voted against the UDI's motion to eliminate the corporate tax increase nevertheless spoke favorably of Chile's low corporate tax rate; the RN proposed its own motion to increase the corporate tax to 16 percent rather than 17 percent.[15] Designated senators who supported the reform package as a whole also expressed concerns over raising the corporate tax.

Eliminating *57 bis.*

In 2005, the Lagos administration employed vertical equity appeals to help enact another income tax base-broadening reform. The tax benefit known as "*57 bis*," inherited from the dictatorship, was essentially a government subsidy for wealthy owners of new-issue stocks that served no justifiable technical ends. The Concertación had long wanted to eliminate this tax benefit, but opposition from business and right curtailed prospects for reform.

However, an unusual opportunity for reform arose during the 2005 presidential campaign. UDI candidate Lavín blamed insufficient progress toward reducing poverty and inequality in Chile on the Concertación, despite the right's history of blocking redistributive reforms: "After 16 years of Concertación governments, there are a million and a half Chileans who live in overcrowded conditions, 190,000 people who live on 37,000 pesos ($65.00 US) a month, and another 6 million Chileans who live on less than 2,500 pesos ($4.40 US) a day."[16] President Lagos responded with the following public challenge: "The famous Article 57-bis is still in force and signifies a tremendous source of inequality…instead of talking so much,

[15] This motion did not come to a vote given that it violated the terms of exclusive executive initiative.

[16] Original Spanish: "después de 16 años de gobiernos de la Concertación, hay un millón y medio de chilenos que viven hacinados, 190 mil personas que viven con 37 mil pesos al mes y otros 6 millones de chilenos que viven con menos de 2 mil 500 pesos al día." Quoted in *La Tercera*, March 27, 2005: "Iglesia pide que los votantes se informen."

how about if tomorrow we introduce a proposal for a new law and in less than 24 hours, Article 57-bis would be struck down?"[17] The government's vertical equity appeal was highly effective. Lavín quickly accepted the challenge, and the right followed his lead in the senate despite business complaints. The bill received almost unanimous approval in congress after only a brief debate. Whereas the Anti-Evasion reform was stalled in congress for almost a year, the 2005 reform was enacted in less than a month.

Because of the high-profile exchange between Lavín and Lagos and the salience of inequality during the presidential campaign, the anticipated political cost to the right of defending business interests was much higher than had been the case in 2000-01 while the government was working to legislate the Anti-Evasion reform. Had the right decided to oppose the 2005 reform, it would have played directly into the government's hand by providing evidence that the right was hindering equity-enhancing reforms in Chile, and that Lavín could not command authority over the unruly right coalition. The right often countered government tax initiatives by framing tax increases as hurting the middle class; yet this approach was impossible because the 2005 reform narrowly affected economic elites. Tax agency data showed that a mere 0.5 percent of adults received 72 percent of the tax expenditure associated with *57 bis*.[18] With the election close at hand, the right feared that voters would punish Lavín at the polls (UDI b 2005).[19]

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[17] Original Spanish: "El artículo famoso, 57 bis, todavía está vigente y significa un tremendo apoyo a la desigualdad… en lugar de hablar tanto, ¿qué tal si mañana mandamos un proyecto de ley y en menos de 24 horas se aprueba derogar el 57 bis?" Lagos quoted in *El Mercurio*, May 10, 2005: "Lagos reta a Alianza a derogar exención tributaria en 24 horas."
[18] SII 2005: 43
[19] *El Mercurio*: May 12, 13, 2005.

Piñera's 2010 Corporate Tax Increase

Income tax politics took an unexpected turn in 2010 when newly-elected right-coalition president Piñera temporarily increased the corporate tax to 20 percent. This reform emerged from an unusual conjuncture of factors. First, a massive and devastating earthquake created major, unanticipated revenue needs that made tax increases imperative in the view of many economists. Informants concurred that the administration would not have considered tax increases had the earthquake not occurred, in accord with Piñera's campaign platform and congruent with the preferences of organized business and the right. Second, Piñera experienced strong political pressure to signal that his administration would not be a government by and for big business. Piñera was one of Chile's wealthiest businessmen, and the Concertación mounted a concerted campaign to delegitimize his presidency on that basis. Leaders within the right coalition judged that Piñera could have won the election by a wider margin had he taken more concerted efforts to alleviate concerns over potential conflicts of interest associated with his extensive business endeavors. These issues continued to plague the administration during its first months in office. Accordingly, government advisors hoped that increasing the corporate tax would signal Piñera's separation from the business world and regain public confidence.

Strategies pioneered by the Concertación helped the Piñera administration legislate the reform. Most importantly, the corporate tax increase was temporary. Moreover, the corporate tax increase was gradually phased *out,* in contrast to the usual Concertación practice of phasing *in* tax increases. The reform stipulated that the rate would fall from 20 percent to 18.5 percent in 2012, returning to 17 percent in 2013. This reform design made the temporary nature of the tax increase more credible and helped win acquiescence from business and reluctant UDI legislators. In addition, the government included several compensations for economic elites, including a reduction of the stamp tax, which business associations had long lobbied to eliminate, and expanded tax credits for charitable donations.

Recent Tax Developments: The 2011-12 Student Protests and New Reform Initiatives

Despite the major political challenges associated with taxing economic elites in Chile, recent developments have created new opportunities for much more substantial tax reform. The 2011 and 2012 student protests that captured the world's attention have dramatically expanded the scope of debate on progressive taxation. Not only did the students' demands for major educational reform create massive new revenue needs, but the students also explicitly demanded that the government finance reform through progressive taxation. As politicians from both the left and the right struggled to improve their abysmal approval ratings and respond to this new organized constituency of young people with significant disruptive capabilities, a major debate on the structure of the tax system commenced. The student offensive compelled the Piñera administration to permanently raise the corporate tax to 20 percent, despite its clear prior intent that the 2010 increase would be temporary, in an effort to mitigate pressure for more radical reform.[20]

The 2013 presidential campaign focused further attention on the issues of taxation and equity. Opposition candidates presented a variety of what in the Chilean context can be viewed as radical income tax reform proposals, in stark contrast with the incremental reforms of previous years. Bachelet's campaign platform proposed increasing the corporate tax rate to 25 percent, eliminating the tax deferral for business income,[21] and lowering the top personal income tax rate from 40 percent to 35 percent — given that broadening the income tax base to include retained corporate profits will significantly increase taxes owed by the Chileans at the top of the income distribution. The right strongly criticized the proposal during the campaign, as expected. However, business assumed a more cautious position of warning that the tax reform—and especially eliminating the tax incentive for reinvested profits—would affect growth, investment, and employment, but with a much milder tone compared to reactions against even modest tax increases in previous years. This cautious approach no doubt reflects business recognition of the dramatically changed political context in Chile following the student mobilizations.

On the whole, business now appears to have accepted a significant income tax increase as inevitable, given strong pressure from the student movement and civil society more broadly as well as opposition gains in the 2013 parliamentary elections. The coalition backing Bachelet (Nueva Mayoría) secured 21 seats in the senate while the right now controls only 17 seats. These results place the right in a much weaker position to veto tax increases.

Given the new balance of power in congress, the central challenge for the Bachelet administration will be ensuring votes from the more economically liberal members of the governing coalition who

[20] See Fairfield (forthcoming) for further analysis of the Piñera tax reform; see Fairfield and Garay (2013) for an integrated analysis of redistributive politics under the Piñera administration (taxation and social spending).

[21] All business profits, whether distributed or reinvested, will enter into the income tax base.

may be less enthusiastic about the magnitude of the proposed reform and the elimination of the tax benefit for reinvested profits. While business-right opposition proved the largest obstacle to tax reform in the past, disagreements within the Concertación occasionally contributed as well (Fairfield forthcoming).

Conclusion

The Concertación faced major obstacles to progressive income tax reform from 1990 to 2010, given the strength of business and the right; these powerful organized actors that sought to keep income taxes low. However, use of multiple reform strategies allowed governments to make some progress at the margins, particularly by restricting or eliminating tax benefits that disproportionately benefitted big business and upper-income taxpayers. These strategies have been used elsewhere in Latin America and beyond to increase taxation of economic elites (Fairfield 2013). Where organized business and right parties were weaker, these strategies have generally facilitated more significant reform.

The value of employing multiple reform strategies and pursuing incremental tax increases when opposition from societal actors and political parties is strong is a generalizable lesson that emerges from the Chilean cases examined in this paper. Reform strategies do not ensure success, yet the more strategies that can be simultaneously applied, the better the prospects. Consider Mexico, for example. In Mexico, linking to social spending has not been as effective as in Chile, in part due to citizens' perceptions that the state will not actually ensure that they receive the promised benefits (Elizondo 2013). Initiatives to broaden the VAT base to include food and medicine have thus far failed. Yet combining progressive, highly elite-targeted income tax increases and vertical equity appeals with linking to social spending might garner greater public support, or at least acceptance—in the worst case, average citizens would be no worse off than at present. The obvious drawback, of course, is that economic elites would strongly oppose measures that aim to directly tax their income and wealth.

Reform strategies from the Concertación's traditional repertoire are sure to feature centrally in Chile's coming tax reform debate. At this early stage, the Bachelet administration's proposed tax reform has already been linked to financing investment in public education, equity appeals are well-formulated—the income tax measures are designed to increase the burden on the wealthiest Chileans by eliminating the favorable treatment of business income—and the modifications will be phased in gradually to assuage concerns over the impact on investment. Although it remains to be seen how significantly the executive branch will need to modify its reform proposal to secure approval in congress, it seems clear that Chile is now poised to enact by far its most substantial progressive income tax reform since the transition to democracy.

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