

STATE BUILDING AND TAXATION IN LATIN AMERICA

Heidi Jane M. Smith

Visiting Scholar, Instituto Tecnológico Autónomo de México

Mobilizing Resources in Latin America: The Political Economy of Tax Reform in Chile and Argentina. By Omar Sánchez. New York: Palgrave Macmillan, 2011. Pp. xi + 245. \$85.00 cloth. ISBN: 9780230114463.

Taxation and Society in Twentieth-Century Argentina. By José Antonio Sánchez Román. New York: Palgrave Macmillan, 2012. Pp. xiv + 245. \$90.00 cloth. ISBN: 9780230341265.

State-Building and Tax Regimes in Central America. By Aaron Schneider. New York: Cambridge University Press, 2012. Pp. xvi + 243. \$90.00 cloth. ISBN: 9781107019096.

Taxing and spending are two main functions of a modern government, and citizens' opinions on how they are taxed matter for creating an effective state apparatus. This is particularly true in Latin America, where states are considered to be weak and tax-to-GDP ratios are relatively low. While many scholars have studied the link between state formation and society through the lenses of fiscal sociology and tax policy, mainly in continental Europe and the United States, social scientists are only now beginning to evaluate this phenomenon in developing countries by using an institutionalist approach.¹

Latin America has one of the world's lowest tax rates per capita, and many people outright do not pay their share. The Inter-American Development Bank (IDB) reports that tax revenues, excluding social contributions, were on average about 17 percent of gross domestic product (GDP) compared to over 30 percent in more developed economies.² The IDB notes that tax revenues from capital income and direct taxation (including income tax) are also low. In many countries, capital income is hardly taxed at all, and deductions are very high with many loopholes encouraging elites to evade paying.³ In Latin America the problems are exacerbated where highly regressive tax systems exist side by side with highly unequal income distribution.

1. See, for example, Sven Steinmo, "Political Institutions and Tax Policy in the United States, Sweden, and Britain," *World Politics* 41, no. 4 (1989): 500–535; Richard E. Wagner, *Fiscal Sociology and the Theory of Public Finance: An Exploratory Essay* (Cheltenham, UK: Edward Elgar, 2007).

2. Ana Corbacho, Vicente Fretes Cibils, and Eduardo Lora, eds., *More than Revenue: Taxation as a Development Tool* (Washington, DC: Inter-American Development Bank, 2012).

3. The IDB suggests that Latin American and Caribbean countries generate a mere 1.4 percent of GDP in income taxes, one of the most progressive taxes to collect, compared to 8.4 percent in developed countries.

Notably, there are very large discrepancies in tax burdens across countries and within states (at the subnational level). They range from the low burdens of countries endowed with nonrenewable resources like Mexico and Venezuela (about 10 percent of GDP), to high levels in countries like Brazil (36 percent of GDP).⁴ Brazil's tax-to-GDP ratio is close to the Organization of Economic Cooperation and Development (OECD) average, but in some countries, such as Peru, Guatemala, and Haiti, government revenue is much lower, ranging between 10 and 20 percent of GDP. This reflects the inability of the government to bring more dynamic sectors of the economy into the tax net.

State-society relations matter for how taxation systems are established within a country. To explore this ground, three scholars recently have published inquiries about the nature of civil society's fiscal interaction with the state by evaluating how Latin American tax systems were built. Coming to the question from the disciplinary perspectives of history and political science rather than the well-worn paths of sociology and economics, the works adopt an institutionalist approach. They include an in-depth single case study, a classic two-country comparison, and a multicountry study. While the first two treat the more developed countries of the Southern Cone, the third examines less-developed Central America.

Mobilizing Resources in Latin America: The Political Economy of Tax Reform in Chile and Argentina, by Omar Sánchez, suggests that while Argentina has failed to produce an appropriate social contract upon which to build fiscal legitimacy, Chile has been successful not only in collecting taxes but also in achieving impressive economic growth and macroeconomic stability sustained for decades. For Sánchez, the typical economic and rational-choice theories used to evaluate tax policy through the lenses of efficiency and effectiveness do not necessarily help us understand why a particular country pursues a specific set of fiscal policies. He evaluates the strengths and weaknesses of institutions by studying the political environment, policy operations, and group interactions that create a particular tax policy. He finds that Argentina constantly changed the rules of the tax game. Middling tax enforcement mechanisms at the national level, weak party systems, and the near absence of organized civil society hindered tax compliance. As a result, an effective state-society pact was never created, and Argentina has been unable to foster an adequate tax base for its citizens. The absence of the formal written rules so necessary for compliance in such elaborate systems has further aggravated Argentina's weak tax enforcement state.

By contrast, Chile has had a strong institutional setting within which to develop its tax system. This has included a stable state apparatus, an institutionalized party system, and a strict policy with an effective technocratic administrative bureaucracy for enforcement. Overall, these attributes have produced fiscal discipline and strong macroeconomic stability. Chile also managed its collective action problem around taxes; as a result, successive governments have been able to negotiate a suitable fiscal policy. Informal institutions ensured collective de-

4. These data vary among sources; whereas the IDB reports revenue 17 percent of GDP for the region and as high as 40 percent in Brazil in 2008; the Economist Intelligence Unit reports 23 percent for the region and 36 percent in Brazil in 2008.

cision making by incorporating nonparty actors into the political system. That strengthened the decision making around tax policy and promoted policy consensus and fiscal consolidation within Chile.

Sánchez compares the 1989–2001 period in Argentina and Chile, focusing on party control of the technical and political aspects of fiscal policy. To assess the strength or weakness of institutions, Sánchez evaluates the cases using a historical path-dependency approach. Examining how the two states institutionalized their political systems, he studies the aggregation of the informal interests of civil society groups and political parties that were engaged in policy making. The author appraises the formal institutions by studying the legislative and executive branches of the state and their shared power to create effective budgets, as well as political party systems and government bureaucracies' capacity to implement sound policy. He also describes the informal rules of the game and blames ineffective tax policy in part on Argentine clientelism and a national tendency toward political movements (i.e., *yrigoyenismo*, *peronismo*, *menemismo*) that were not then fully institutionalized into formal political parties with coherent ideologies.

While the book is well written and describes and documents well the economic policies of both countries, its method of evaluation of institutional factors presents intertwined causal variables without identifying which ones are most significant. Variables include formal and informal rules of the game, political parties, civil society, efficient bureaucracies and technocratic policy makers, each influential to a greater or lesser degree, depending on how effective the state was in incorporating group demands into the process of the budget debates. The comparative case study methodology is at times overly simplified and gives insufficient credit to the longer historical nation building that the two countries underwent in the nineteenth and twentieth centuries. The singular focus on policy making from 1989 to 2001 creates an unsatisfactory binary typology. Nor is there a full description of Argentina's decentralized federalist state structure, which complicates Argentina's governance compared to Chile's centralized unitary system.

Those wishing for deeper coverage of Argentina's complex history and institutions would do well to turn to historian José Antonio Sánchez Román's *Taxation and Society in Twentieth-Century Argentina*. Sánchez Román argues that Argentina had a highly developed tax system prior to Juan Domingo Perón's first presidency (1946–1955), but it was later dismantled. The author offers a historical account to explain why today there is low tax compliance in Argentina. He traces the origin of Argentina's income tax, which was implemented in 1932 as part of a graduated, progressive tax structure. The tax was approved by a legislature elected via proportional representation. Carefully reading historical records, Sánchez Román demonstrates that most Argentine taxpayers paid their portion of the tax. Around the same time, and against the backdrop of fiscal policy reform, a well-intentioned but now archaic revenue-sharing scheme was developed to appease the interior provinces.

Sánchez Román argues that rational-choice theories focused on efficiencies in public finance and economics do not explain how and why the Argentine tax system eroded over time. Rational agency may not account for political elites' destruction of Argentina's successful tax compliance system, which operated

with a minimum of coercion in the early part of the twentieth century. Here Sánchez Román draws on the theory of bounded rationality as developed by Herbert Simon in 1957. Simon suggested that rational-choice theory misses the abstract values and specific context of a particular society.⁵ Institutional analyses remedy this, using the evolutionary process of institutions through the fragmentation of interest groups to better understand the perception and capacities of the state. Sánchez Román also highlights the importance of Margaret Levi's theory of "predatory rule," which centers on the constant bargaining process between economic elites, to suggest that interest groups play a major role in institutional development processes.⁶ For Sánchez Román, Argentina had a "quasi-coercion" process, a type of institutional development that was erratic and often created an adversarial tax state. The noncompliance society that developed after Perón's first presidency was less prone to engagement and established new norms and rules of the game that favored less taxation of the working classes. As does Omar Sánchez in *Mobilizing Resources in Latin America*, Sánchez Román argues that the modern bureaucracy never developed sufficient efficiency to improve its tax collection and citizen compliance with tax law. Massive noncompliance has plagued Argentina ever since.

Sánchez Román's book is peppered with tidbits on Argentina's economic history that may surprise readers. For example, he shows that the pre-Perón, more progressive tax system was built by industrial elites in Buenos Aires and that socialists later rejected the proposal, suggesting it did not go far enough to protect society. Another little-known fact was that during the first years of his presidency, Perón instituted a household vigilante system to ensure that citizens paid their taxes. Perón's administration deepened the progressiveness of the tax scheme between 1946 and 1949 but later abandoned it in order to pay for his government's commitment to public expenditures that heavily favored the new industrial working class located in the capital city.

This close analysis of a specific historical moment has useful fine-grained descriptions of civil society organizations and their efforts to impact tax policy. One deficit in the book is its lack of a global context. Another is the dearth of information about how economic development, population size, income flows, and waves of immigrants may have influenced the country's state-building endeavors. There is no chart of comparative demographic data to illustrate the size and composition of the tax base. The author's parsimonious account of the tax proposals advocated by various groups makes it difficult to understand what alternative tax policy Argentina might have adopted, and the book's rendition of how the Congress approved and interpreted these proposals can be difficult to follow. Regardless, this revisionist history should be credited with bringing attention to the role of civil society actors, providing a richer context for institutional analysis of how the Argentine tax system evolved.

5. Herbert A. Simon, *Models of Man: Social and Rational; Mathematical Essays on Rational Human Behavior in a Society Setting* (New York: Wiley, 1957).

6. Margaret Levi, *Of Rule and Revenue, California Series on Social Choice and Political Economy* (Berkeley: University of California Press, 1988).

In the last pages of the text, Sánchez Román introduces a new hypothesis for readers to contemplate (without providing much analysis). He questions whether a modern taxation system can be institutionalized before the development of a full-fledged industrial society, given that Argentina's early attempt to do so proved unstable. Western Europe and the United States had already established modern labor relations before modernizing their tax systems. For him, a post-Fordist society—where labor's relation to technology and investments shifts from heavy industry to computers—may need to be created before taxing these workers. Although left undeveloped, his proposal is interesting and merits further research.

Aaron Schneider presents a multicountry study with the potential for more robust conclusions in *State-Building and Tax Regimes in Central America*. Utilizing a multilayered methodology, Schneider evaluates Central America's efforts to create positive civic relations after the destructive wars in Nicaragua, El Salvador, and Guatemala during the 1980s. Schneider's primary concern is how to encourage economic elites to pay their taxes, especially when transnational corporations and international development specialists occupy a particular territory.

Schneider's work examines the globalization of Central America, a region with especially low tax collection. The author analyzes tax collection through the criteria of tax capacity, universality, and progressiveness. The issues of universality and progressiveness are more of a concern in Central American countries than in the Southern Cone because external elites shaped their industrialization and continue to influence state-building processes. A crucial question for Schneider is how these countries have responded to such outside influences.

Using both within-case and across-case methodology, Schneider evaluates Guatemala, Honduras, Nicaragua, Costa Rica, and El Salvador to better understand how and why tax collection patterns have varied in and across these countries. He finds that all five countries have had steady growth in their tax collection since the "lost decade" of the 1980s. Further, he argues that agrarian reforms and state modernization in the wake of peace accords have transformed relevant actors in many of the countries, necessitating a reexamination of how policies are crafted in the twenty-first century. Schneider demonstrates these differences by using secondary data sets, primarily from the University of Oxford and the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), which are publicly available.⁷

The case studies of Guatemala, Honduras, and El Salvador show variation in how globalized actors have been engaged in the postconflict state-building processes. Schneider argues that while El Salvador took an "inside-out" approach, in which domestic economic and social elites worked together to engage outside actors, Honduras took an "outside-in" approach, in which international conglomerates determined the type of tax policy they wanted and then lobbied local elites to make the appropriate policies and laws amenable to their needs. Finally, in Guate-

7. The University of Oxford Latin American Economic History Database (OxLAD) can be accessed here: <http://www.lac.ox.ac.uk/moxlad-database>; and United Nations Economic Commission for Latin America and the Caribbean (ECLAC) tax data may be accessed here: <http://estadisticas.cepal.org/>.

mala neither transnational elites nor local social, economic, or nongovernmental organizations were able to make cogent decisions in order to create a coherent tax policy. Schneider argues that their lack of cohesiveness comes from the path-dependent histories of traditional sectoral actors such as business associations, as well as urban and rural social movements, and from newer social organizations. Societies were highly fragmented after the civil wars and have yet to fully recover and integrate into formal politics via political parties or well-institutionalized organizations. The lack of organization among these groups weakens state building.

Although Schneider's book provides an extensive literature review covering fiscal sociology and globalization, and his comparative case work does aid theory building by demonstrating the value of institutionalist approaches to the study of state building in relation to tax policy, his primary concern is with the policy implications of his work. He wants to know how to encourage tax collection when globalized economic elites, transnational corporations, and international development specialists are involved in state building. By looking at groups and their interactions, analyzing the different interests diverse actors hold, and comparing their decision-making methods, Schneider concludes that external elites can be managed to a lesser or greater extent depending on the institutional strength of the state.

Beyond the new historical and institutional analyses provided by Sánchez, Sánchez Román, and Schneider, there are several additional theories that seek to explain why more tax collection and reform efforts have not been undertaken in Latin America. Often the public finance literature blames the problem on a lack of political will and weak institutions.⁸

The literature suggests there are three main administrative obstacles to the development of simplified tax structures and broader tax bases.⁹ First, lower-income countries do not have a sufficiently developed private sector from which to secure corporate taxes. In order to encourage business development, countries may eliminate taxes or collect lower amounts in accordance with trade and investment liberalization. Second, because public bureaucracies are seen as corrupt and inefficient they lack credibility, so many countries faced with a need to secure additional revenues just opt to increase the value-added tax (VAT). This tax is not a direct tax and often can be regressive. Property and income taxes are generally encouraged precisely because they are considered to be direct and more progressive. However, low compliance rates mean that many states do not succeed in collecting these taxes even if they exist on the books. Finally, academic debates

8. See, for example, Juan Gómez Sabaini, "Evolución y situación tributaria actual en América Latina: Una serie de temas para la discusión," in *Tributación en América Latina: En busca de una nueva agenda de reformas*, ed. Oscar Cetrángolo and Juan Carlos Gómez Sabaini, 39–130 (Santiago: ECLAC / United Nations, 2006); Eduardo Lora, "El futuro de los pactos fiscales en América Latina," Working Paper 650 (Washington, DC: Banco Interamericano de Desarrollo, 2008).

9. Luiz De Mello, "Latin America's Public Finances: Governments in Latin America Have Made Enormous Progress in Improving Their Fiscal Management in Recent Years; but What Are the Next Steps?" *OECD Observer*, no. 254, March 2006.

revolve around the administrative capacity of lower-level governments to collect taxes. This relates to the decentralization policies that spread through many countries in the region beginning in the 1980s. The administrative structure of the bureaucracy and the levels or tiers of government may play a role in the administrative proficiency of the state.

While rational-choice theories can help define the types of tax policies a country might choose to develop, they are not sufficient to determine whether a particular policy will be implemented effectively.¹⁰ For example, when equity concerns have been downplayed, policy advisors encouraged the use of the VAT, a regressive tax. But simplifying tax regimes and reducing the hurdles and the time required to comply with bureaucratic procedures is only one step toward better tax administration. Administrative reforms—changing the management and collection of taxes—are also needed, and they may be as important as the kind of taxes (VAT, sale, personal income, property, social security, etc.) that a country chooses to collect, if not more so. Sound enforcement mechanisms and an independent administration for managing collection and government redistribution of revenues are of particular import. Better development and advocacy of auditing systems are necessary. Overall, revenue collection authorities are more effective when they operate outside of finance ministries and thus have a measure of autonomy from the government and its politics.

10. Jonathan Di John, "The Political Economy of Taxation and Tax Reform in Developing Countries," Research Paper No. 2006/74, July 2006, United Nations University and World Institute for Development Economic Research, UNU-WIDER.