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POLITICAL ECONOMY ISSUES OF TAXATION IN LATIN AMERICA

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POLITICAL ECONOMY ISSUES OF TAXATION IN LATIN AMERICA

by

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Abstract

This paper is part of a wider research on "Tax Systems and Tax Reforms in Latin America", carried on at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi.

The political economy of Latin America is a crucial issue. In the last decades many Latin American countries have experienced a democratic transition, but poor economic performances. In particular, contrary to the predictions of the political economy literature on democracy and economic development, fiscal pressure has remained low, especially income taxes, despite the democratic transition. This puzzling evidence can be reconciled with political theories, if we include the role played by vested interests, financial sector and populist economic policies.

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1. Introduction

Most of Latin American countries have only recently experienced a transition towards democracy. With the exception of "old" democracies such as Costa Rica or Colombia, while in the 1950s only a minority of Latin American countries could be considered democracies, in the 1990s a large majority of them accomplished the transition to a democratic political organization, although with several specific features.

The democratic transition has relevant implications for economics. The recent political economy literature has analyzed the double link between democracy and economic development. On one side, countries should become more democratic as they become richer (Lipset 1959). As pointed out by the "modernization" theory (see Boix (2003), Barro (1996), Giavazzi and Tabellini (2005), Acemoglu *et al.* (2004-5), Acemoglu and Robinson (2006)) markets can prosper only in a political framework characterized by constitutional liberties and democratic practices[1]. On the other side, democracy affects the economic outcomes, and, in particular, it may affect public policies: Boix (2003) suggests that in democratic regimes taxes and public spending should be higher than in autocratic regimes, since in these last ones a substantial part of the electorate is excluded from the decision-making process. Boix (2003) also shows that under the same level of per capita income, when modernization starts, the government is larger in a democracy than in an autocracy, because redistributive welfare expenditures, such as pensions, health care and unemployment benefits, rise after the introduction of a democratic regime. This is particularly true in countries characterized by high ex-ante income inequality: in a democracy, the larger is the group of low-income individuals, the higher are the votes in favor of redistributive public policies (in the spirit of the Meltzer and Richard's seminal paper (1981)), and thus the higher are taxation, especially on labor income, and public expenditures.

Recently, Persson and Tabellini (2006) have deeply analyzed the double link between democracy and economic development, identifying a new crucial variable, 'democratic capital,' which is a measure of the persistence of democracy in a society: democratic capital stimulates growth, which in turn

[1] See Cacciatore *et al.* (2006) for the problematic evidence in this theoretical context of South and East Asia.

contributes to consolidate democracy creating a virtuous circle of democracy and development.

The predictions of this literature however are at odds with facts in the Latin America context. In general, the economic performances of Latin American countries have been rather poor and disappointing in particular in the years right after democratization: on average the lowest growth rates are in the 1980s, that is during the transition period. This poor economic performance is difficult to be explained according to the "modernization" theories. Focusing in particular on taxation, contrary to the predictions of Boix (2003), the democratic transition in Latin America has not been associated with a growing fiscal pressure, nor with a rebalancing of tax composition in favor of more labor and less consumption taxes. We find that countries where fiscal pressure is increasing show this raising path even before the democratic transition. This suggests that there is no systematic relation between the democratic transition and an increase of fiscal pressure[2]. In other words, since the level of fiscal pressure depends on many factors (per capita income, macroeconomic variables, etc.) the democratic transition does not appear to have *ceteris paribus* a crucial positive impact. This result can not be explained if we represent the functioning of a democracy through a standard median voter model, which aggregates voters' preferences: in this area, among the most unequal region in the world (see Gómez-Sabaini and Martner (2007) and Barreix *et al.* 2006), the popular demand for redistribution is very high. Following Meltzer and Richard (1981), we would expect significant increases of taxation with the democratic transition. This is not what happened in Latin America and thus a puzzle emerges.

Rodriguez (2001) suggests that other political factors have to be included to account for Latin America's overall poor economic outcomes: political instability, inequality in the distribution of political and economic power, corruption and rent-seeking, vested interests.

In this paper we focus on taxation and we investigate into this "puzzling" evidence: enormous changes in the political organization of these countries, mainly the democratization process, have not been associated with a raise in the fiscal pressure.

[2] Notice that we focus on tax revenue. However in countries such as Chile, Colombia and Mexico, non-tax revenues, related to the exports of non-renewable resources, are also important and they have considerably increased in the last years (see Jiménez and Tromben 2006).

After assessing this evidence, we make an effort to provide possible explanations of this “puzzle”. This is not an easy task. All possible arguments that we will mention have perhaps a role in this complex evidence and the best explanation has to be thought as a combination of them. We argue that specific elements which characterize Latin America may have played a role in keeping the fiscal pressure low despite the democratic transition: (i) the quality of democracy, with a low level of representation and a relevant weight of lobby, elites, interest groups; (ii) the development of financial institutions; (iii) the heritage of populist economic policies.

We should also remember that international organizations, such as IMF and World Bank, have played a crucial role in the design of fiscal systems and fiscal reforms in many Latin American countries. The tax systems in place thus strongly reflect the plans of these external organizations, not necessarily in line with the preferences of their democratic societies.

The paper is organized as follows: next section focuses on democracy and summarizes the main facts of the democratic transition for a sample of Latin American countries (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay and Uruguay). Section three shows the existence of a puzzle comparing fiscal and political data. Section four provides alternative explanations of this puzzle. Section five concludes.

2. Democracy in Latin America

In the 1980s and 1990s, with the exception of Costa Rica and Colombia, all Latin American countries of our sample experienced a democratic transition. This happened in 1983 in Argentina, in 1985 in Brazil and Uruguay, in 1989 in Chile, in 1991 in Paraguay and in 1994 in Mexico. In each country the democratic transition, which has represented the defeat of the armed forces’ political power, has been characterized by specific features.

In Argentina (see Bès 2007), serious economic problems, mounting charges of corruption, public denunciation of human rights abuses and, finally, the 1982 defeat by the UK in the Falklands War, all these facts contribute to discredit the military regime that was in power since the coup against Isabel Perón in 1976. On October 1983, Argentines went to the polls in elections found by international observers to be fair and honest and the large turnouts for mid-term elections in 1985 and 1987 demonstrated continuous public support for the new strong and vigorous democratic system. As for Brazil (see Afonso and Barroso 2007), the military maintained power from 1964 until March 1985 because of political struggles within the regime and local elite. In 1984 many public demonstrations held in the main cities made clear that military rule could not continue and that Brazilians were starting to require changes in the electoral system to directly elect their president. So, after the end of the military dictatorship, Brazil went into a troubled process of re-democratization, with the New Constitution in 1988 and the first direct presidential election won by Collor de Mello. In Uruguay (see Barreix and Roca 2007), the unpopularity of the *de facto* military government emerged in 1980 with the "no" in the referendum proposing a change in the constitution. In 1984, after massive protests against the dictatorship, national elections were held and the new administration, led by Sanguinetti, started to implement economic reforms and to consolidate democracy. The Chilean military regime instead (see Cominetta 2007) lasted until 1988, when in a plebiscite 55 percent of the voters denied a second term to General Pinochet, the chief of a junta established by the army in power since 1973. Paraguay (see Ferrario 2007) was progressively isolated from the world community during Stroessner's 34-year reign, characterized by severe limitations of political freedoms and persecution of the opponents. In 1989, Stroessner was overthrown in a military coup headed by General Rodríguez that easily won the presidency in elections, instituted political, legal, and economic reforms and initiated a rapprochement with the international community. A democratic system of government was then established by the 1992 Constitution. As for Mexico (see Alvarez 2007), since 1929 the Institutional Revolutionary Party (PRI) monopolized all the political branches. It was only through the electoral reforms started by president Salinas de Gortari and consolidated by president Zedillo, by the mid 1990s, that the PRI lost its majority in Congress and the democratic transition started.

Despite these specific features that gave birth to the democratization process in each country, a common element of the successive development and, to a certain extent, of the current maturity of democracy in Latin America relies in its economic foundations. Latin American citizens seem to support democratic regimes mainly because they are convinced that these are beneficial for their economies. 72 percent of Latin Americans believe that democracy is the only political system which can contribute to economic development (Latinobarometro polls 2004 in Santiso 2006). Interestingly, this value increases up to 84 percent in Uruguay and 79 percent in Argentina, the countries which have experienced the most dramatic shocks and financial crisis in the area. In other words, as noticed by Santiso (2006), it seems that Latin American citizens are becoming "politically mature". They can distinguish between democracy as a political system, which they consider the best environment for growth (on average, according to the poll on Human Values 1995-2000, again in Santiso 2006, more than 80 percent of Latin Americans approve of democratic ideals), and the economic outcomes reached by the functioning of their democratic governments and political leaders, which may fail to satisfy their expectations. In fact the average rate of satisfaction about the accomplishments of democracy does not exceed 62 percent.

A crucial implication of this trend is that Latin American citizens are particularly sensitive to the economic performances (especially in terms of growth and inflation) accomplished by their leaders, and they are ready to punish those leaders who do not achieve the expected economic goals. At the same time, this implies that economic reforms are a main platform proposed by political parties to gain votes. This is especially true in the context of taxation, where reforms may represent a politically feasible and optimal strategy to gain support, since there still exists potential space for both increasing the fiscal pressure and rebalancing the composition of the tax revenue, currently mainly dominated by indirect taxes (see Gómez-Sabaini and Martner 2007). However, fiscal policies do not really follow this suggested path.

3. Taxation and democracy: a puzzle?

Contrary to the predictions of the literature, and also contrary to what we would expect in a democratic context with essential economic foundations, after the democratic transition Latin American economic policy has not given a priority role to taxation and redistributive policies. In the period 1980-2004, while the democratization process develops, the tax burden in percentage of GDP remains quite low (in 2004 the average value for Latin America countries is 16.6 percent (ILPES CEPAL 2007) compared with an EU(25)-average of 39.3 percent (EUROSTAT 2006)) and quite stable. The tax structure remains dominated by indirect taxes, with a low weight of income and capital taxes.

Figure 1 shows for each country the evolution of a democratic index and of the tax revenue in the period 1980-2004. Data on tax revenue as percentage of GDP come from ILPES CEPAL statistics and the democratic index is POLITY2 from Polity IV dataset (2005). This dataset contains many information on political regimes characteristics and transitions of a variety of countries from 1800 to 2004 and it is largely used in the most important political economy studies. According to some specific political features, such as political competition, political freedoms, constraints on the exercise of power by the executive and guarantee of civil liberties, each country is related to a one-year democracy (DEMOC) and autocracy (AUTOC) index, both ranging from 0 to 10 (strong democracy or strong autocracy). POLITY2 is a combined polity score, computed by subtracting the AUTOC score from the DEMOC score and so ranging from -10 (strong autocracy) to +10 (strong democracy)[3].

FIGURE 1 NEAR HERE

According to Figure 1, there is no systematic relation between the evolution of democracy and the evolution of taxation. A part from Colombia, which experienced a significant increase in tax revenue/GDP in the period 1980-2004 (the democratic transition here happened much earlier, in 1957), this ratio slightly raises over time in some countries (Argentina, Paraguay, Uruguay, Colombia, Costa Rica) and is almost unchanged in others (Mexico, Chile). Notice that for the first group of countries this slight increasing path of tax revenue in percentage of GDP seems to start even before the democratic transition, and it should thus be explained by other factors (for instance per capita income, macroeconomic performances). The timing of the transition seems to have no relation with changes in the tax burden. In other words, it is very difficult to

[3] Actually, POLITY2 is a revised combined polity score that differentiates from POLITY (see Polity IV Project Dataset User's Manual (2005) for more details).

argue that tax revenue increase after the democratic transition, as we would expect from the theories.

Concerning the tax structure, notice that indirect taxes (consumption) are more important than direct ones (income and capital). According to ILPES CEPAL Statistics from 1990 to 2004, in Mexico in 2004 direct taxes amount to 4.6 percent of GDP while indirect taxes reach 5.3 percent of GDP. The difference in the relative weight of direct and indirect taxes is much more evident if one considers the tax structure of Paraguay and Uruguay. In Paraguay, during the analyzed period, the ratio between indirect taxes and GDP is generally more than four times that of direct taxes. In Uruguay, the importance of consumption taxes is confirmed by the fact that their revenue in 2004 are 14.3 percent of GDP against 4.3 percent of GDP of income and capital tax revenue. In Costa Rica, direct taxes increase from 2.2 in 1990 to 3.8 percent of GDP in 2004, but indirect taxes are much more important, reaching in the same years 8.6 and 9.2 percent of GDP respectively. In Chile, direct taxes/GDP and indirect taxes/GDP stay around 5 and 11 percent respectively during the 2000s. Argentina's tax structure is becoming more balanced: in 1990 the difference between the revenue of consumption and income taxes was 5 points of GDP while in 2004 it decreases to 3.3. Even in Colombia, we observe a similar trend: in 2004 direct and indirect taxes amount each to 7.2 percent of GDP. Brazil represents the only exception. In this country taxes on income and capital are always higher than consumption taxes.

Given the high ex-ante inequality that characterizes Latin American countries (see Barreix *et al.* 2006), this structure of taxation with a prevalent weight of indirect taxes implies a high degree of regressivity[4], and thus an even more unequal ex-post income distribution. This is exactly the opposite of what predicted by a standard median voter's model (*à la* Meltzer and Richard 1981), which would suggest that, in a democratic country, when ex-ante inequality is higher, a poorer median voter votes for higher taxes and redistributive policies and thus ex-post inequality is reduced.

How can we reconcile this puzzling evidence with political theories? We try to address this question in the next section.

[4] Notice that the recent introduction of multi-rates VAT may alleviate this regressivity result (see Sabaini and Martner 2007).

4. Possible explanations of the puzzle

In this section we propose possible explanations of the puzzling evidence on taxation and the democratic process in Latin America. These explanations can be grouped in three types: (i) the quality of these democracy suffers from low levels of representation, while vested interests, or lobbying and interest groups play a crucial role, leading to economic outcomes rather different than median voter's choices; (ii) financial institutions, which are crucial for tax enforcement, have typically provided a low value added to Latin American firms which use them, and thus a high degree of "disintermediation" characterizes these economies; (iii) the economic policies suffer from the heritage of populism, which in previous political regimes was keeping taxation very low in order to maintain the support of the mass, even at a cost of increasing debt[5].

4.1 The quality of the democracy and the role of vested interests

One of the main issues of democracy in Latin America concerns the quality of these democracies. The POLITY2 index captures some fundamental characteristics of a democracy. However, to what extent these democracies have a substantial rather than a formal character? This would help explaining why the economic outcomes are somehow different from the ones that would emerge in a true democracy.

In a democracy, a small and homogenous number of elected individuals are in charge to represent the large variety of public opinion and preferences. The quality of a democracy can thus be judged, at least in part, by the level of representation. In a democratic context, representation matters for the durability and stability of the democratic regime itself. However, the relation between representation and durability is not unambiguous. On one side, Diamond (1996) argues that under-representation may affect citizens' support for the system and thus increase the likelihood of a reversal to non-democratic forms of government. On the other side, as noted by Huber and Stephens (1999), in countries where poverty and inequality are prevalent, such as in Latin America, a lack of political representation may be associated with democracy

[5] Notice the opposite experience of New EU Members, in which the transition from an autocratic regime to a democracy is associated with an increase of taxes and public expenditures, in line with the heritage of the former socialist regimes.

consolidation, because if subordinated classes are not represented, the elites can keep their interests more secure and reduce the possible threats of breakdown. However, once the economy develops, representation may increase without affecting the stability of the democracy.

The level of representation in a democracy may also play a crucial role in explaining economic policies. We expect that a democratic transition will not induce a significant increase in taxes, even in countries with high income inequality, when low-income groups are not enough represented, i.e. the representation level is low. Our countries lack of representation, a fact that may help to reconcile the evidence on taxation and formal democratic systems. Luna and Zechmeister (2005) build an index of “mandate or issue representation”. Using data for 1997 and 1998 and considering the correspondence between party elites and party electorates on a variety of issues grouped in five areas (economic, foreign investment, religion, regime, law and order), they find the highest scores of this index in Chile and Uruguay, followed by Argentina. Colombia and Costa Rica stay in the intermediate range and Mexico and Brazil are the less representative countries. The old democracies, Colombia and Costa Rica, seem to be characterized by only a shallow connection between elites and citizens (see in particular the experience of Colombia until 1974), but there is room for a significant improvement in the effectiveness of political representation in the young democracies too. In other words, there is room for these new democracies to acquire a more substantial character.

While in Latin America democracies political parties weakly represent voters’ political preferences, they are largely influenced by the action of lobbies, elites and interest groups. In scarcely representative democracies, the government shapes policy more to the pressures of special interests than to the preferences of the general electorate. The role of lobbies in the political process has been emphasized by Grossman and Helpman (1994). They argue that once solved their internal free-rider problems, special interests groups can provide political contributions to influence the government’s policy. The lobbying process can be seen as a two-stage non cooperative game. Each interest group gives the government a contribution schedule that maximizes the aggregate utility of its members in which all possible policies are linked to specific contributions. Then the government chooses a policy and collects from each group the related contribution. The increasing ability to contribute and to deliver blocks of votes improves the position of special interests in the eyes of the government.

Following this reasoning, taxation in Latin America may be seen as the result of the pressure of interest groups, which lobby to keep taxes low. In particular, the elites in power are generally near the rich. They are interested in keeping down taxes not only for themselves, but also for middle classes, in order to obtain their support in the political competition (see also Bernardi *et al.* (2007) and Gómez-Sabaini and Martner (2007)).

4.2 Financial institutions

In a democratic system electoral terms and mandates impose a radical transformation of the temporal horizon. In a shorter time horizon, which depends on electoral terms and mandates, the appropriate time management becomes a top priority for the government. Financial institutions are developed in this direction, since they may allow governments to act as though they had infinite horizons at their disposal.

Once introduced and developed, financial institutions may also play a crucial role for tax enforcement. According to Gordon and Li (2005a), this role becomes very important to understand why poor and rich countries have different tax revenue as a percentage of GDP and different composition of the tax burden. In poorer countries firms receive a low added value (i.e. benefits) from using the financial sector than in richer ones. This affects the threat of "disintermediation". When firms rest on the financial sector, the government can obtain many information about the scale of the firm's economic activity and use them to improve tax enforcement. Thus, the modest value added coming from the financial sector reduces the poor government's ability to collect tax revenue[6].

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[6] Cash transactions are used here as a synonym of informal economy, difficult to control and to tax. Firms that are not strongly dependent on financial sector can rely on cash transactions, which do not leave paper trail, in order to avoid (high) taxes (i.e. the cost of using the financial sector). This may increase the shadow economy.

Following this reasoning, a possible explanation of the low tax burden in poor countries is that the under-development of the financial sector, bringing about “disintermediation”, may be responsible for low tax enforcement and thus low revenue collection.

Moreover, if the benefits from using the financial sector are low, the design of the tax structure will be oriented towards a more intensive use of corporate income taxes, and tax collection will be focused on capital intensive firms. This narrow tax base in fact depends more heavily on the financial sector and has very low chances of “disintermediation”. In this context, countries may use an inflation tax as an instrument to raise the costs of cash transactions and create efficiency and revenue gains by improving the capital and labor allocation between taxed and untaxed sectors and shifting new firms to using banks as intermediaries.

The results of Gordon and Li (2005a) are consistent with the Latin America context, which shows a low tax burden and a still relevant inflation tax (see Gómez-Sabaini and Martner 2007). As a consequence, a democratic transition may not induce a significant increase in tax collection, if it is not joined by a significant economic development, which would induce a further development of a well functioning financial sector and, in general, of efficient fiscal institutions.

Gordon and Li (2005b) claim that this most intense use of taxes on corporate income in poor countries can also be justified using the lobby model of Grossman and Helpman (1994). Capital intensive firms are interest groups actively lobbying to keep a low level of corporate taxation. When these firms are not numerous, such as in poor countries, they are not able to lobby effectively and, as a consequence, the level of CIT in the tax structure increases. However, contrary to the evidence, this would suggest that the overall level of taxation is also higher in poor countries, where only few firms actively lobby.

4.3 Populism

During the 1980s in Latin America land owners exercised political monopoly that does not allow the political system to start fiscal and economic reforms to create a sufficiently high tax base. After the World War I and the great depression of the 1930s this political monopoly stopped giving way to political parties and military leaders, supported by urban labor union and import-substituting industrialists. Political scientists named this alliance between labor and capital owners against land owners “populism”. It concretizes in a set of economic policies designed to achieve specific political goals such as mobilizing support within organized labor and lower-middle-class group (Kaufman and Stallings 1991). Among the different experiences of Latin American populism we can mention the Péron regime in Argentina from 1973 to 1976, the Echevarría government in Mexico from 1970 to 1976 and the five years of Sarney governance in Brazil from 1985 to 1990. Populist politics gave rise to populist policies oriented for example to keep taxation very low in order to maintain the support of the mass, even at a cost of repeated cycles of growing budget deficits and increasing debt.

The heritage of these populist economic policies is our third argument that may help explaining the low level of tax burden observed in the young Latin America democracies. As mentioned in section 2, the democratization process is perceived by citizens as an improvement and a way to attain economic development. In this sense, it could be difficult for politicians elected in a sufficiently free and fair context to increase taxes with respect to the previous political regimes. In particular, the political cost of increasing income taxes in these low-income countries, in terms of loss of support from the population, may be so high that the government prefers to tax corporations (and provide a system of incentives for them, see Marenzi and Maffini 2007).

5. Conclusions

Latin America suffers an “excess of inequality” (World Bank 2005). The high levels of inequality have been quite stable over time. Thus, they are not affected by economic or political changes that characterized the last decades in this area of the world. Inequality ex-post is not much better than inequality ex-ante. This suggests that taxation does not have a redistributive impact. Fiscal pressure is in fact quite low and indirect taxes dominate direct ones in many countries’ tax structure.

Though the high ex-ante and ex-post inequality may sound consistent with the non-democratic phases of the XX century, it is quite surprising that they remain similar after 20 years of democracies. Political economy median voter’s theories would predict an increase of taxation and redistributive policies, which, instead, has never started. We have suggested that other political factors are still relevant in Latin American democratic decision making, which may help explaining this apparent puzzle: a low level of representation of political parties, large power of lobbies and interest groups, high "disintermediation" from the financial sector which reduces tax enforcement, the heritage of populist economic policies. Reducing the role of these factors seems to be essential to a democratic increase of fiscal pressure and redistribution which, lastly, would reduce inequality. This in turn may also have an important positive impact for growth and the overall development of Latin America (see Aghion *et al.* 1999).

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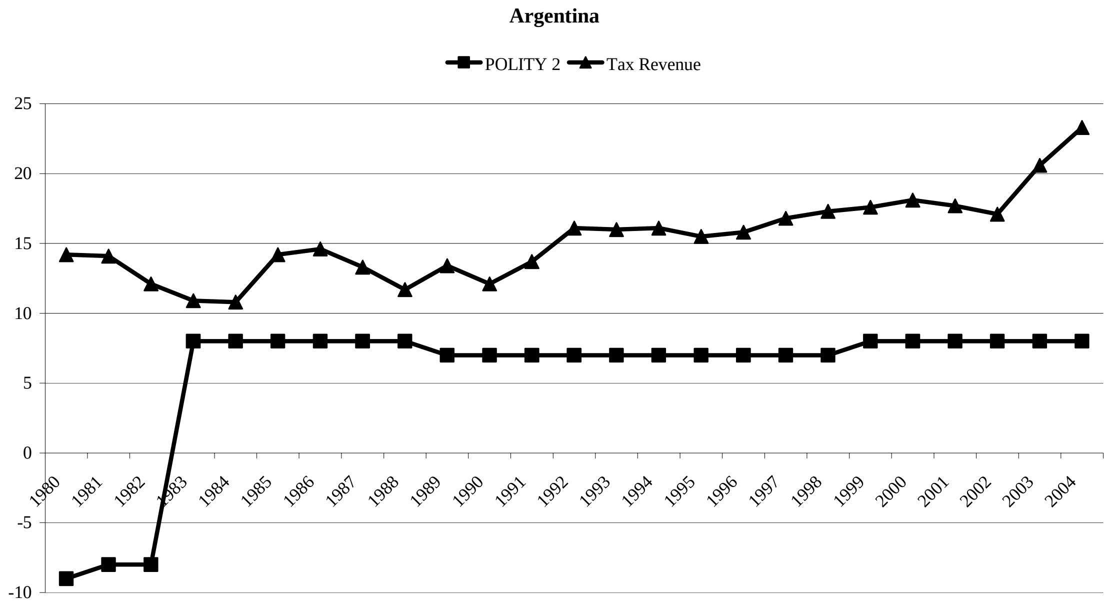
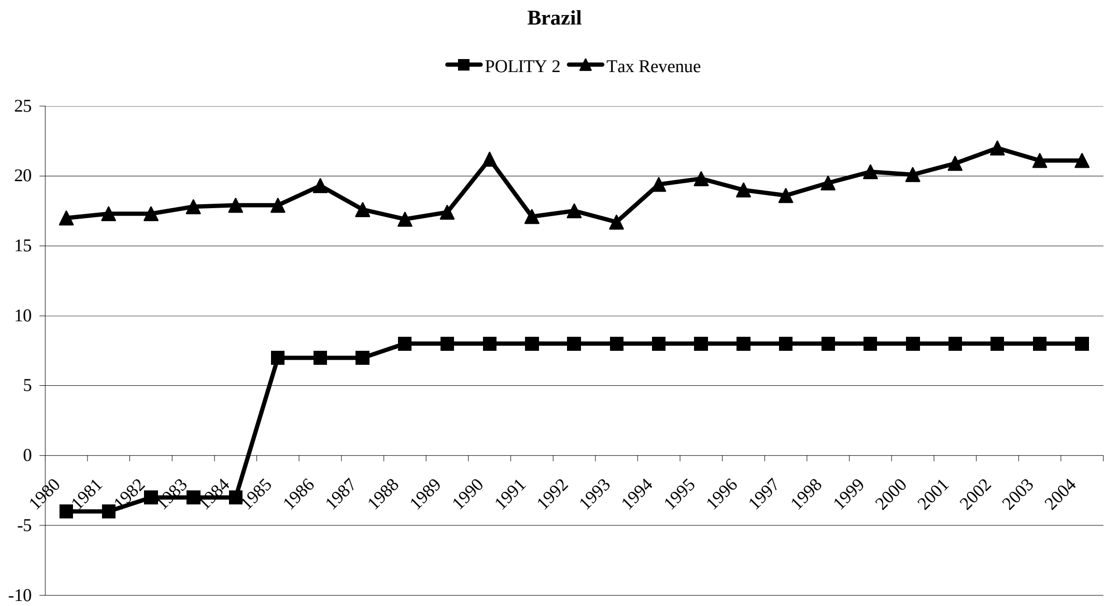
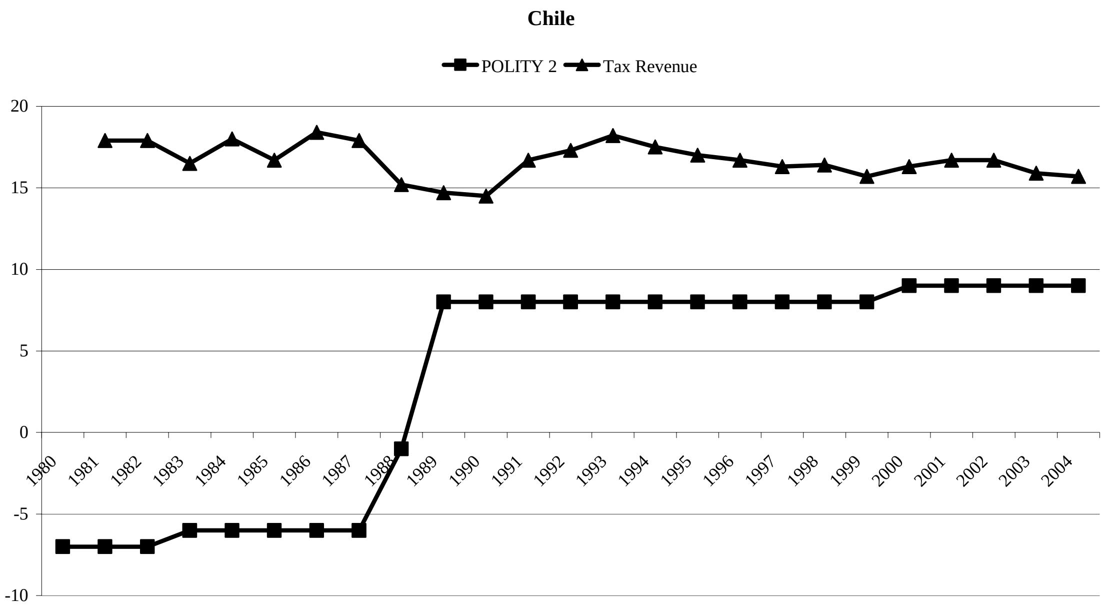
Figure 1 The evolution of POLITY2 and Tax Revenue in Latina American countries






Chile
POLITY 2
Tax Revenue
20
15
10
5
0
-5
-10
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
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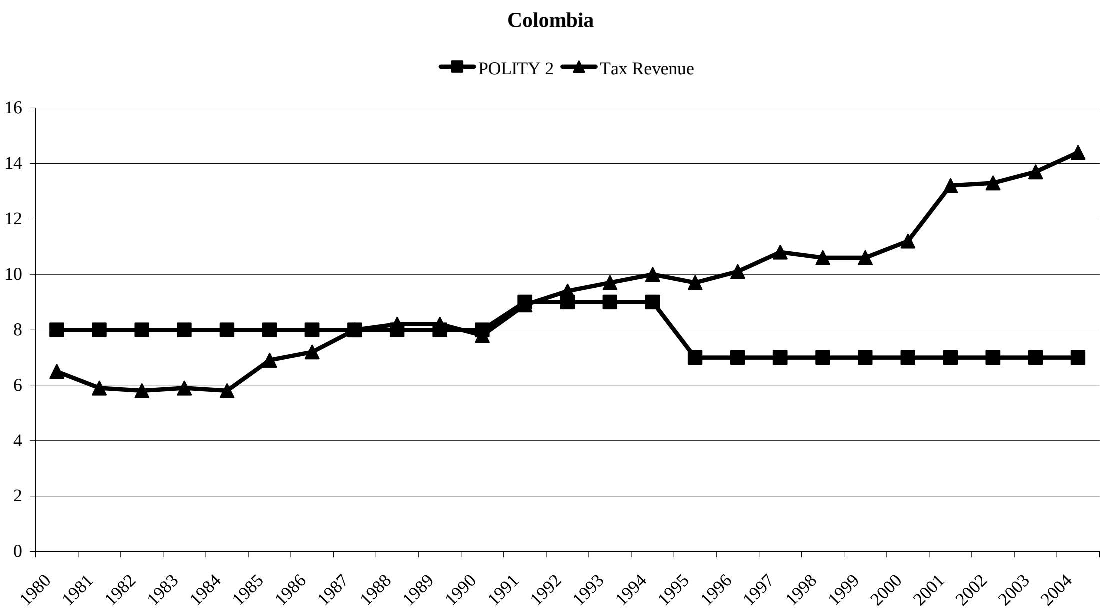
1997
1998
1999
2000
2001
2002
2003
2004


Colombia
POLITY 2
Tax Revenue
16
14
12
10
8
6
4
2
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
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1997
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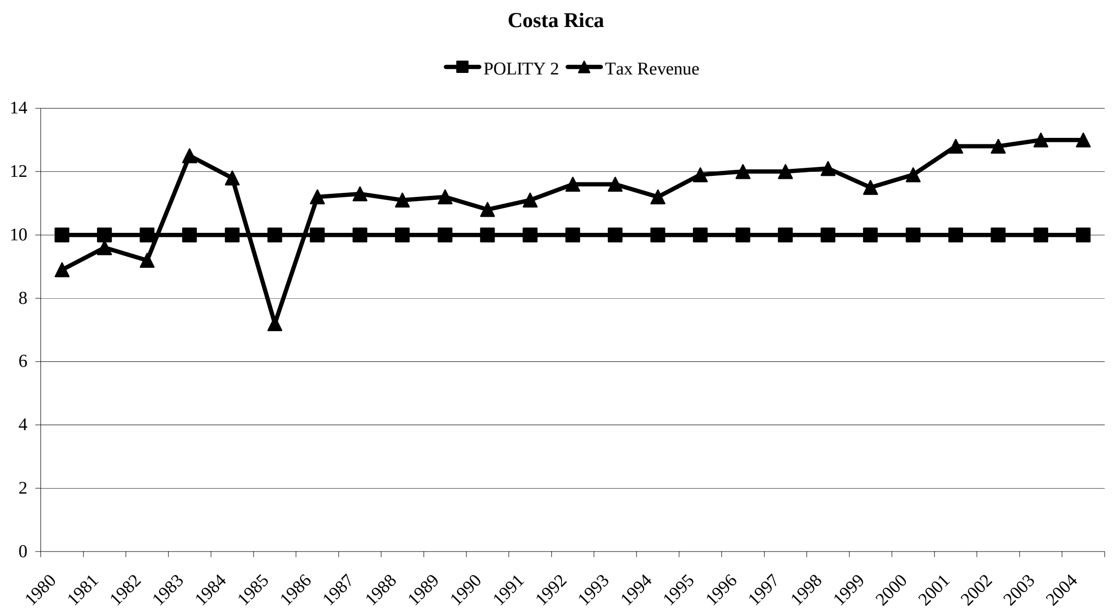
2003
2004


Costa Rica
POLITY 2
Tax Revenue
14
12
10
8
6
4
2
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
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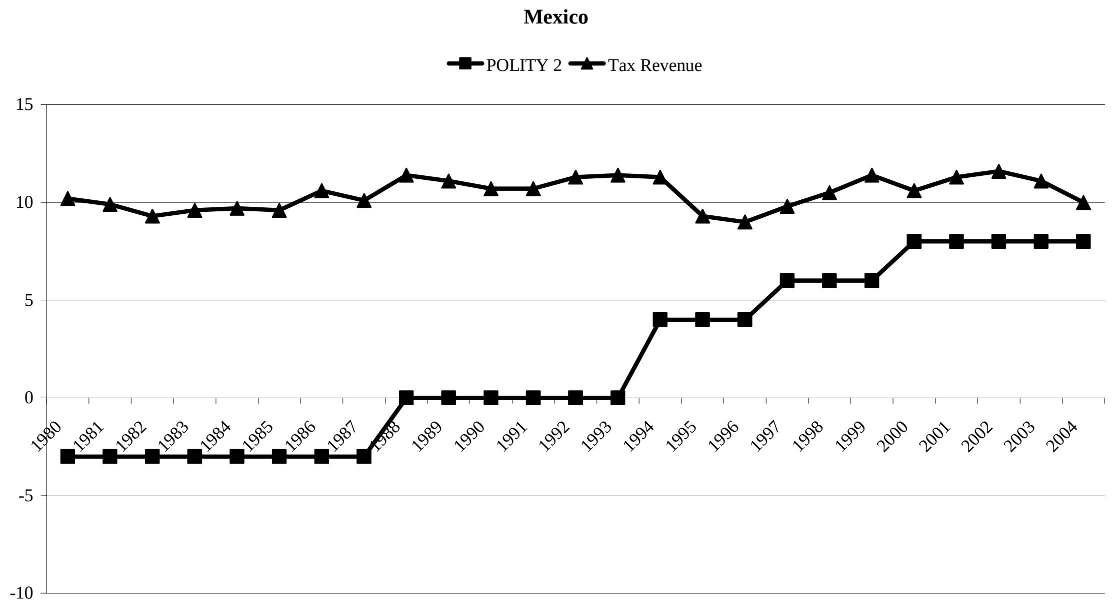
Mexico
POLITY 2
Tax Revenue
15
10
5
0
-5
-10
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
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1994
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1999
2000
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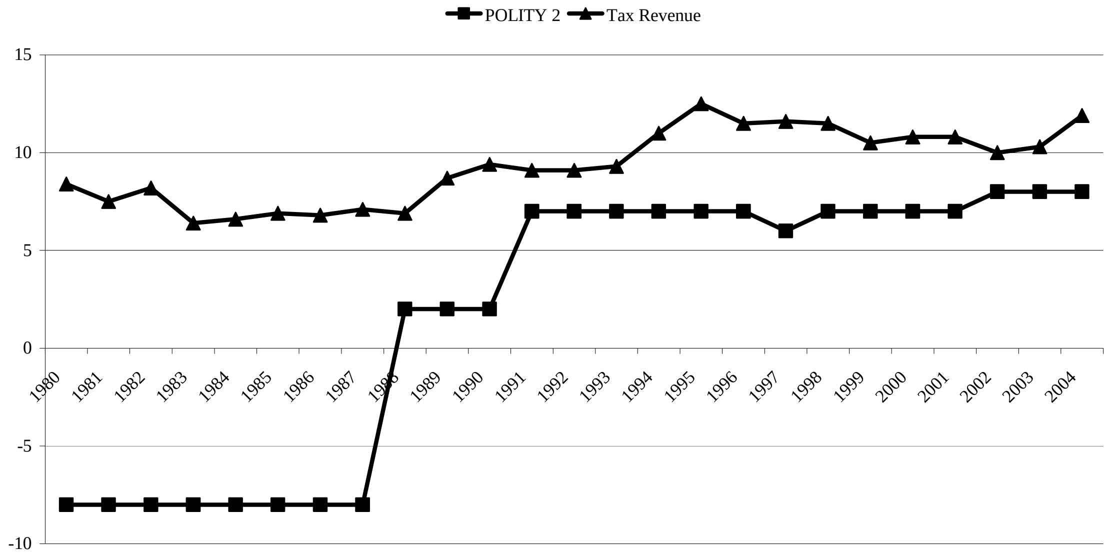
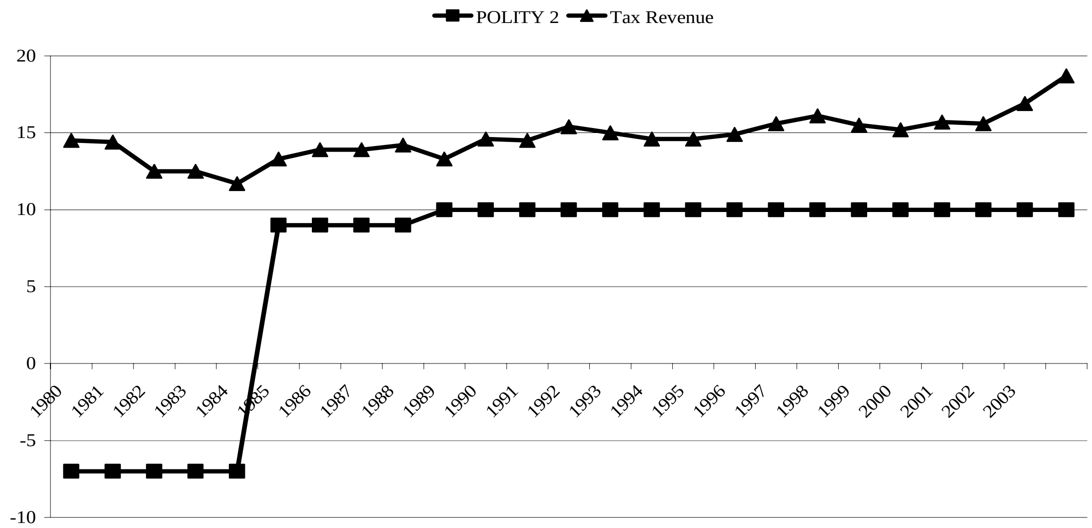
2003
2004

Paraguay



Uruguay



Note: Tax Revenue for Argentina and Brazil refers to general government
Source: POLITY2 from Polity IV dataset and Tax Revenue from ILPES CEPAL.