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Aaron Schneider
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Revenues, States, and Central America

Building states is both more important and more difficult in an age in which resources, information, products, and (occasionally) people flow across borders with greater speed than ever before.[1] Under such circumstances, the tasks of state-building must be undertaken anew, calling into question the responsibilities of states to citizens, the responsibilities of states to holders of capital, and the responsibilities of states to other states. No issue captures these potential conflicts more clearly than taxation, by which state authorities muster the resources needed to govern and in the process negotiate contributions from citizens. Citizens form groups and associations to negotiate their obligations and the benefits they expect in return and establish political institutions to formalize these state-society relationships. In time, this can have lasting impacts on political practice and regime outcomes (Lieberman, 2003; Gehlbach, 2008). There has been significant attention given to the role of revenues in building early Western European states, and even some attention given to formative moments of state-building in developing countries (Tilly, 1992; Centeno, 2002). However, we have limited insight into what happens when economies change significantly, with new leading sectors, new patterns of social organization, and new requirements of state authorities. How do governments sustain themselves in the face of more mobile sources of revenue, and how do new social actors fit into already established political institutions?

[1] Whereas globalization renews debates on state-building, the topic has attracted repeated attention from social science observers over the years, including during the formation of the European interstate system and the expansion of industrial capitalism (Weber, 1968), the process of decolonization (Huntington, 1968), and the reform of state institutions in developing countries (World Bank, 1997).

Struggles over tax are a particularly good place to look for evidence that sectors emerging as a result of global integration are pursuing a state-building agenda. Taxes express in fiscal terms the way groups organize and advance a project for their state, and it is in taxes that we can find evidence that state-building is occurring, or not, and in what ways. Taxes institutionalize who pays for what benefits enjoyed by whom. As recent scholarship on the topic has noted, "Taxes formalize our obligations to each other. They define the inequalities we accept and those that we collectively seek to redress. They signify who is a member of our political community, how wide we draw the circle of 'we.' They set the boundaries of what our governments can do. In the modern world, taxation *is* the social contract" (Martin, Mehrotra, and Prasad, 2009: 1).

This book studies state-building under globalization by comparing the politics of revenue in five Central American countries: Guatemala, Nicaragua, Honduras, Costa Rica, and El Salvador, with particular emphasis on El Salvador, Honduras, and Guatemala. These countries have relatively similar economic and social structures, buffeted in comparable fashion by global forces beyond their control. At first glance, their responses appear similar, with governments of the region largely adopting the set of policies denoted in the Washington Consensus, especially when it comes to trade integration, privatization, and market liberalization (Williamson, 1990; Bird, 1992). In revenue terms, the countries have generally dropped trade taxes, raised domestic indirect taxes, and marginally increased revenue capacity (Agosín, Barreix, and Machado, 2005). Viewed in these terms, the state-building experiences of Central American countries are instructive for those curious about all developing countries.

On closer examination, however, the countries diverge in the precise fiscal changes that have occurred. These divergences are revealed in the degree to which states increase their revenues, apply the rules and regulations of tax regimes universally across sectors, and mobilize revenues from wealthy sectors, especially newly emerging transnational elites adapted to an integrated global economy.[2] Together, these dimensions characterize the tax regimes taking shape in the region.

[2] Victor Bulmer-Thomas, in observing Central American economic history over the last century, noted that "although Central America has had no political unity … it has had a certain 'economic unity' as a result of its subjection to common external influences. These have filtered through domestic institutions to affect each economy in slightly different ways. Thus, the region exhibits both conformity and diversity and the problem facing an author is to see the one without losing sight of the other" (Bulmer-Thomas, 1987).

These dimensions can be summarized in the concepts of tax capacity, universality, and progressivity. The capacity to extract revenues is fundamental to government functioning; a state cannot be considered authoritative over a territory if it cannot collect taxes.[3] For this reason, the amount of taxes collected is a useful indicator of the legitimate capacity of the state, measured in the amount of national wealth mobilized in revenues. This is most directly measured in terms of revenues as a percentage of GDP, although revenues per capita, absolute or nominal revenues, or revenues in relation to spending or debt can provide other impressions of the relative amount of resources available to state authorities (Peters, 1991).

For some comparisons, wealth mobilized through other means, such as social security or natural resource royalties, are relevant, but taxes are distinctly useful indicators of state-society relations, as taxes are "unrequited" payments to the state, requiring a basic degree of state legitimacy and embeddedness in society (World Bank, 1988: 79). Taxes are especially useful because there is no quid pro quo, no direct exchange. Other types of contributions, such as fees for services or the profits of public enterprises, may contribute to state coffers and thereby allow the state to provide public goods, but they do not have the characteristic of an open-ended, individual commitment to the state. Margaret Levi (1989: 49) highlights this aspect of the tax relationship in terms of "quasi-voluntary compliance," as tax collection must rest on a basis of consent and not simply the threat of punishment or the promise of some immediate benefit. In a Latin American region where taxes are generally low, Central American governments have traditionally taxed at some of the lowest rates, making any advance in capacity a rich opportunity to explore exactly what has happened in political terms.

The second dimension of tax regimes, tax universality, is the degree to which tax law is applied in equal fashion regardless of the way wealth is created, stored, or transferred. For example, universality suggests that incomes generated in one sector are not treated differently than incomes from another, nor are the sales of one kind of goods versus another. The butcher and the baker who earn an equal sum do not pay different amounts of tax, regardless of to whom and where they sell their wares. Everyone pays their part. In this sense, the problem of universalistic taxation is very much a coordination problem, as groups must agree not to seek particular treatment and benefits within the tax

[3] North (1982: 21) suggests state "boundaries are determined by its power to tax constituents."

code (Bates, 1989; Steinmo, 1993). This aspect of tax regimes gets to the horizontal equity of taxes, which is the degree to which individuals or firms of similar resources carry similar burdens. In the absence of horizontal equity, the impression that similarly situated competitors are not paying the same amount creates a sense of injustice and a resistance to payment, complicating collection and suggesting that government is either too captured or too weak to balance the tax burden among different sectors.

One way to approach universality of tax is through the bases and rates defined in tax legislation. Reforms that narrow or widen bases or apply special rates to specific bases have important horizontal equity implications, creating particular relationships with sectoral groups rather than a universal relationship with the citizenry as a whole. Not only is particularism damaging to the legitimacy of taxes, it also complicates collection by forcing administrations to manage multiple rates and rules.

The attention to fairness also implies concern with vertical equity, or the progressiveness of a tax system. This refers to the degree to which those with more wealth pay a greater share. In addition to an ethical concern with distributive justice, progressivity also follows from the intuition that the marginal utility of income decreases with wealth; taking an extra dollar away from a wealthy person has a far lower impact on welfare than taking an extra dollar away from a poor person (Lieberman, 2001: 94).

To measure vertical equity, several indicators are useful. Traditional divisions of tax bases into direct and indirect categories are a start, with income, property, and capital gains taxes in the direct category, assumed to fall more heavily on the wealthy. Although this may not perfectly measure the impact on inequality, there are both objective and subjective reasons to consider this categorization useful. First, most evidence suggests that direct taxes are more progressive than indirect taxes (Musgrave, 1959). In addition, people perceive direct taxes in that way. Opposition to consumption taxes is often made on the basis of a perceived inequity in tax burdens, as poor people pay a greater portion of their income to consume their basic needs.

Other measures of inequality capture the degree of progressivity more precisely, such as the distributional impact of taxes, with Gini coefficients before and after taxes among the most common (Goñi, López, Servén, 2008). Estimating Gini coefficients is a difficult task, as it depends on assumptions about behavior had a tax not occurred; and most studies that use Gini coefficients in this fashion model different possible taxpayer responses.

An additional aspect of progressivity is the ability to tap into the most dynamic and lucrative sectors. In the current international political economy, these are the sectors adapted to globalized production and markets. Finding a way to engage dynamic sectors is especially important for governments in highly unequal societies. Dynamic sectors offer the large sums necessary for financing public needs, and these sectors tend to be concentrated, making it more convenient to find the resources here rather than scattered throughout the rest of the economy.

Also, bargaining over tax with the actors producing in these sectors offers an opportunity to exchange information and identify the ways state power can be used to promote dynamic sectors. Less-developed countries have long faced the problem of export enclaves with few links to the rest of the economy. In addition, the primary products they tend to export face competition from other producers and offer limited returns, much lower than the finished products they import. In a globally integrated political economy, individual entrepreneurs may be able to identify market niches, but they need state power and resources if they are to survive, extend linkages to other sectors, and scale up to more complex production processes.

There is much to be gained through state engagement with dynamic sectors over the issue of tax, but it is no easy task. Many of these firms and sectors barely existed two decades ago, forcing states to design new administrative tools and legal authority to tap into undefined tax bases and previously unknown entities. Tax experts call these tax "handles," and they have to be invented anew.

This is a delicate task, as clumsy or excessive attempts to collect can weigh heavily on the few profitable activities appearing in a poor economy. The state must be careful not to scare off incipient industries and firms, especially those that can quickly move to other jurisdictions. This is particularly the case under liberalized capital market and trade regimes, when the state has few tools to compel emerging elites to stay home.

Tax regimes are characterized by capacity, universality, and progressivity; and in many ways it is progressivity that holds the key. Unfortunately, as will become clear, the state-building projects advanced by emerging elites in Central America have occasionally demonstrated the path to greater capacity and universality, but they have yet to stumble on the politics of progressivity.

Central America is a particularly good place to study the difficult task of constructing tax regimes, as the governments of the region have never been particularly effective at mobilizing revenues. The region has been the source of lament for at least forty years for international observers who worry about the failure to tax enough to support basic state activities, and especially the failure to tax leading sectors (Joint Tax Program OAS/IADB, 1966).[4] Indeed, observers have long been convinced that there is a connection between the failure to tax the wealth of powerful elites and the fragility of democratic politics in the region (Best, 1976). Historically, Central America presents a perverse version of "no taxation without representation" – for long periods the region has enjoyed neither.

Much of our understanding of democratic weakness and underdevelopment in the region comes from the rich comparative historical literature that traced the paths producing military authoritarianism, patrimonial dictatorship, and democratic transitions (Stone, 1992; Rueschemeyer, Stephens, and Stephens, 1992; Paige, 1997; Yashar, 1997; Mahoney, 2001). These studies share the conviction that weak revenues contributed repeatedly to regime breakdown and lackluster development, as fragile governments pitched into crisis when economies slowed or revenues proved insufficient to meet popular demands, elite rivalry, or external challenges.

By contrast, these studies do not locate revenues at the heart of their analysis of state construction. They neither explain moments at which revenues increase, nor do they explore the way changes to revenue regimes express alternative efforts by emerging elites to enact state-building projects. This study, by focusing specifically on revenues, can identify those rare and isolated moments in which tax regimes modernize and describe the alternative state-building projects they reflect.

By exploring the tax implications of state-building projects, the study might even offer some hope. Revolutionary upheavals of the 1970s and 1980s threatened states with breakdown; the debt crisis and economic stagnation of the 1980s cut off resources; and subsequent stabilization, peace agreements, economic transformation, and democratization generated new demands. At least since the 1990s, this has provoked recurrent fiscal crises of Central American states, which have been met with hundreds of efforts to renegotiate tax regimes in terms of new laws, administrative bureaucracies, and changes to bases and rates. Outcomes have been mixed.

Among the three cases studied most closely here, El Salvador has increased revenues and applied them more universally over the last two decades, although the tax structure has not particularly improved

[4] A similar concern directed those exploring developing countries more generally, "Will Underdeveloped Countries Learn to Tax?" (Kaldor, 1963).

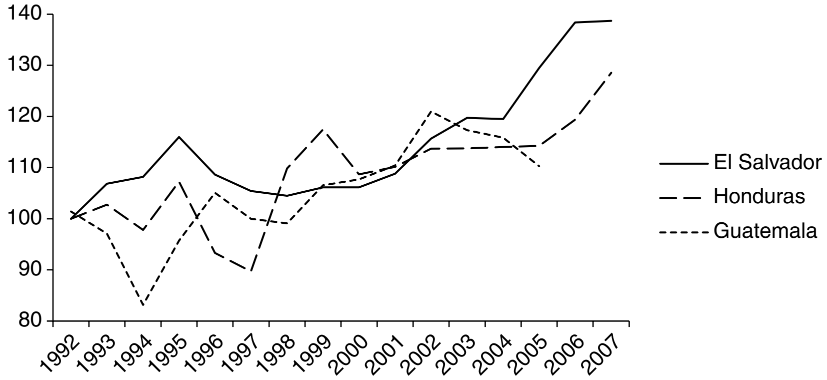

FIGURE 1.1. Change in tax/GDP since 1990.
Source: Author calculations from United Nations data collected by the Economic Commission of Latin America and the Caribbean (ECLAC or CEPAL, in Spanish), www.cepal.org/ilpes.

distribution nor has it tapped into the most internationalized segments of leading sectors – the operations of Salvadoran financiers outside Salvadoran territory. Honduras has seen less significant and more infrequent increases in revenue capacity and has even witnessed some increases in progressivity, but both capacity and progressivity have been eroded through the steady extension of particularist benefits to narrow groups. Finally, in Guatemala the revenue regime has remained pocked full of particularist holes, with limited capacity and no gains in progressivity. This book seeks to explain the continued weakness of tax regimes in the region while also tracing the moments and processes by which steps forward are taken. In prior work, colleagues and I described this process as "two steps forward and one step back," as all countries in the region took steps to improve tax capacity, but they have done little to fight particularism and inequity and have reversed some of their hard-fought gains in capacity (Schneider, Agosín, and Machado, 2008).

As an indication of the kind of changes occurring, Figure 1.1 displays the amount of change in tax regimes in terms of tax capacity over the last fifteen years. For each of the countries, tax as a percentage of GDP in 1992 is set to 100, with subsequent years appearing as increases or decreases on that base. With only a slight slowdown in 1996–1997, El Salvador increased its revenues fairly smoothly, reaching a total almost 40 percent higher than where it started. Honduras increased by almost 30 percent, but there were almost as many downturns as there were upticks. Guatemala increased by only 10 percent.

These changes raise some fundamental questions about what is happening in the region. How has El Salvador increased its revenues so markedly? Does this mark a new chapter in the kind of state governing that small, war-torn country; or have revenues increased merely to benefit the objectives of a narrow elite? What does the 2009 election of the former guerrilla, leftist opposition mean? What about Honduras, where revenues have advanced but infrequent attempts to raise them have been interspersed with deterioration and backsliding? Further, what does the 2009 coup tell us about the kind of state being built in Honduras and the implications for ongoing changes to the tax regime? Finally, what is going on in Guatemala? How can a country make significant occasional gains yet make only minimal headway overall? What does this tell us about the ability of newly emerging elites to get their act together and advance a state-building agenda?

These questions attend to deep social and political processes. In particular, tax regimes are shaped by contemporary patterns of state-building.[5] Those patterns are devised by elites empowered by processes of global integration and negotiated with other actors through political institutions. Because emerging elites vary, as do the sectors they encounter and the institutions in which they operate, state-building looks different across the region. Tax regimes are the outcome of these state-building projects, and they reveal divergence across the region.

It may seem strange to talk about Central American state-building in the new millennium, almost two hundred years after independence. Yet, state-building is precisely what is occurring in response to global integration, as governments adapt existing institutions and invent new ones.[6] As in other moments in Central American history and other parts of the world, contemporary economic transformations produce new leading sectors, which pursue policies and institutional changes to secure their political access and their needs of the state. These needs include infrastructure, policy frameworks, and human capital formation to expand their activities and accumulation. To accomplish these tasks, they devise state-building projects composed of the policy changes and institutional adaptations they need from the state.

[5] "Taxes underwrite the capacity of states to carry out their goals; they form one of the central arenas for the conduct of state-society relations, and they shape the balance between accumulation and redistribution that gives states their social character" (Brautigam, Fjeldstad, and Moore, 2008: 1).

[6] This echoes Fukuyama's definition of state-building: "the creation of new governmental institutions and the strengthening of existing ones" (Fukuyama, 2004: 1).

The concept of state-building will be developed more fully in Chapter 2, but for now it is appropriate to raise questions about the leading sectors that design a state-building project, how they relate to other groups and negotiate a national agenda, and how those plans are filtered through and shape already existing, and newly created, political institutions. The core variable distinguished among the state-building projects in the region is the structure of emerging elites.

Newly emerging elites share certain characteristics. Based in small countries with small domestic economies, they must export; this requires them to insert and reinsert themselves in changing international markets. Above all, current patterns of international insertion are transnational in the sense that Central American producers operate within production processes that are themselves integrated across borders. With low labor costs and close geographical proximity, Central American countries have become processing zones, importing materials for assembly and reexport, often to the United States. Central American firms have identified opportunities in transnational processes, including assembly manufacture for export; nontraditional agriculture, tourism, and financial and other services; as well as absorbing the remittances of Central Americans who now live outside the region but send money home. Whereas transnational sectors are largely similar across countries, they diverge in terms of the way elites from these sectors organize themselves internally and relate to other groups, concepts labeled here as *cohesion* and *dominance*.

Cohesion refers to the patterns of internal organization and interest articulation that characterize emerging elites. Cohesion is important because it indicates an ability to unify around a single, coherent, state-building agenda. To pursue this task, emerging elites combine within social and economic organizations such as family networks, firms, and business associations. In political terms, it is here that they undertake collective action to coordinate what they need from the state. Cohesion is indicated by relations among rival firms and factions of the economic elite, especially within business associations, and how these associations and their members carry state-building projects into public policy. Political vehicles include political parties, individual leaders taking on electoral and governmental roles, think tanks to articulate their interests and policies, sectoral lobbying, and more informalized pressure through family and personal connections. Across the region, clear differences emerge in the strategies of interest articulation and aggregation among emerging elites, characterized here by the degree of cohesion.

This book also explores the relationship of new elites to other actors. As new sectors emerge, sunrise firms engage with rivals and challengers, such as elites from declining firms in sunset sectors, popular actors, state bureaucrats, and politicians. To the degree that transnational elites can impose their interests over rivals, or convince them to share an interest in expanding transnational accumulation, transnational elites can be viewed as dominant actors within the domestic political economy. Dominance is necessarily a relational term, requiring analysis of the interests and capacities of other actors, as well as the incentives and constraints placed on them by existing political institutions.[7] In the highly unequal societies of Central America, where popular sectors are numerous and have provided support to social movements, antisystem parties, and revolutionary uprising, the relative strength of popular sectors deserves particular attention. Still, it is the relative dominance of emerging elites that is critical, as it captures the degree to which their state-building project is likely to advance.

Together, the cohesion and dominance of emerging elites form the crux of the argument made here about the kind of state-building project undertaken in each country. This echoes other studies of capitalist factions, emphasizing their internal organization and relationships to other sectors and the state (Ross Schneider and Maxfield and Schneider, 1997; Shadlen, 2005). In some ways, this study most closely resembles the approach to capitalist factions taken in Rueschemeyer et al. (1992).[8] In a comparative historical study of democratization across regions, Rueschemeyer et al. suggest that the emergence of a domestic bourgeoisie is propitious for democracy but only if balanced by other sectors, including state actors and popular forces. Their argument hinges on three variables: "the balance of power among different classes and class coalitions ..., the autonomy of the state apparatus and its interrelations with civil society, and the impact of transnational power relations" (Rueschemeyer et al., 1992: 5). Central America is included among their cases, focusing on the period around the Great Depression and its aftermath, when democracy emerged in Costa Rica, but elsewhere domestic bourgeoisies were too weak with respect to oligarchic elites who were occasionally aided by U.S. intervention.

7 Mann (1986) takes such a relational approach to state-building processes, exploring the relationship between and among social groups and state actors in the construction of early Western European states.

8 Formal models suggest a balance of class power is propitious to democracy because it lowers elite fears of the democratic majority (Acemoglu and Robinson, 2006).