1

Tax Policy and Economic Elites

Going Where the Money Is

Policymakers around the globe have faced contentious debates and high-stakes political battles over tax policy as they struggle to satisfy a wide range of pressing revenue needs, from closing gaping budget deficits that threaten macroeconomic stability to securing sustainable funding for welfare state maintenance or expansion. In Latin America, tax reforms that target economic elites are an obvious option – this region is home to some of the world's most unequal democracies, yet the rich generally pay very low taxes. Although at first glance, many readers might expect democracy to empower average citizens at the expense of the rich, policymakers often have either avoided initiatives to tax economic elites or failed in their efforts to do so. Others might anticipate that economic elites enjoy inherent advantages that privilege their interests over those of average citizens. Yet economic elites are not always able to secure the policies they prefer. In some cases, governments have proposed and successfully enacted reforms that increase taxation of economic elites. Through comparative analysis of tax policy reforms in Latin America, this book develops a broad theoretical framework for explaining how and when economic elites' interests prevail in market democracies and how much scope policymakers can create for equity-enhancing reforms.

To meet revenue needs during the decades following economic liberalization and structural adjustment, governments in Argentina, Chile, and Bolivia all considered initiatives to tax the extensive income, profits, and wealth concentrated in the hands of economic elites, be they capital owners, big businesses, landowners, or high-income professionals. Yet the scope and fate of these initiatives varied across the countries. Whereas Argentina enacted significant tax increases on economic elites, reforms were marginal in Chile and Bolivia. Closer scrutiny reveals that reforms also varied across distinct tax policy areas and over time, particularly in Argentina and Bolivia. Leading theories, including those that attribute progressive tax increases to elite cohesion or to median voter preferences, as well as those that associate lack of reform with capital mobility or the overwhelming influence of money and wealth, cannot explain this variation.

The framework I develop to explain the scope of tax policy proposals, legislative outcomes, and the timing of reform focuses on the power of economic elites, especially business actors. Business – whether as individual firms and investors or as organized political actors – plays a central role in tax politics and economic policymaking more broadly, particularly in Latin America's highly unequal democracies. I draw on the classic concepts of structural power and instrumental power from early business politics literature. Structural power can be thought of as "investment power," while instrumental power can be thought of as "political power." I argue that when economic elites have strong power of either type, their interests shape policy outcomes.

Structural power arises from the profit-maximizing behavior of individual firms and capital owners. If policymakers anticipate that a reform will provoke reduced investment or capital flight, they may rule it out for fear of harming growth and employment. Structural power requires no organization or political action on the part of economic elites; instead, market signals coordinate their behavior in the economic arena. In contrast, instrumental power entails engagement within the political arena and deliberate actions to influence policy, such as lobbying. I identify sources of instrumental power that fall under two categories: relationships with decision makers that provide access and may create bias in favor of economic elites, and other resources, including cohesion, that help economic elites pressure policymakers more effectively. Both structural power and instrumental power vary over space and time. Instrumental power may also vary across sectors or subtypes of economic elites within a given country. Structural power, meanwhile, is highly context-specific; it cannot be reduced to capital mobility or a sector's economic importance, but also depends on the incentives a particular policy creates and ultimately on policymakers' expectations about the aggregate economic outcomes of multiple individual investment decisions.

The power of economic elites is a critical and often underemphasized variable in political economy,[1] and it is particularly important for taxation, a policy area that affects elites' core material interests. Whereas business politics literature historically posed a dichotomy between structural and instrumental approaches, I treat structural power and instrumental power as complementary. I argue that taxing economic elites will be difficult when either their instrumental power or their structural power is strong – policymakers may even eliminate tax increases from their agenda in anticipation of costly political battles and/or disinvestment. The more types and sources of power economic elites enjoy, and the more institutionalized their sources of power, the more

[1] Likewise, Schrank (2007: 191) calls for a return to "old-fashioned power politics" in political economy.

significant and consistent their influence will be: their interests will prevail to a greater extent in policymaking. Popular mobilization can occasionally counterbalance or even overwhelm the power of economic elites. And strategies that cultivate favorable public opinion or temper elite antagonism can help governments legislate incremental tax increases. However, governments have much more scope to tax economic elites whose structural power and instrumental power are both weak.

To briefly sketch how this framework applies to the country cases, economic elites in Chile had multiple, strong, and institutionalized sources of instrumental power, including cohesion and ties to right parties, that discouraged governments from attempting to legislate anything but marginal tax increases. In Argentina, economic elites lacked these sources of power and tended to be much weaker; governments therefore were able to legislate more significant tax increases. However, certain sectors did have other sources of power (instrumental and/or structural) during specific periods that allowed them to defend their own particular interests. Bolivia in the early 2000s is an intermediate case; economic elites' instrumental power was weaker than in Chile but stronger than in Argentina. During this period of extreme social unrest, economic elites were not able to keep reforms they disliked off the agenda as in Chile, but they were more successful than their Argentine counterparts at defeating initiatives later in the policy process – unless popular sectors mobilized in favor of reform.

By carefully examining tax policymaking processes, including the critical but often overlooked stages of agenda formulation and proposal design, this book yields insights about the mechanisms through which economic elites exert influence in market democracies. These insights contribute to a reemerging literature on business power and inform ongoing theoretical debates on the relationship between democracy, inequality, and redistribution. The book further contributes to research on state-society fiscal bargaining by providing a systematic basis for assessing elite taxpayers' bargaining power and by offering a distinct perspective on the causal effects of elite cohesion on extractive capacity.

In addition, this book helps fill major empirical gaps in two important literatures: research on welfare provision in developing countries, and research on economic reforms in Latin America. Many authors argue that sustainable and inclusive social protection requires tax capacity, yet this aspect of welfare state development has received much less attention than the politics of social spending (Haggard and Kaufman 2008; Huber and Stephens 2012).[2] In some cases, major political constraints to expanding social protection lie on the tax policy side of the fiscal equation. Likewise, despite the fundamental importance of taxation – which is critical for political and economic

[2] Others note that reallocation can finance welfare expansion despite tax constraints (McGuire 2010, Garay 2014).

development – political scientists studying Latin America's far-reaching economic reforms have paid much more attention to policy areas such as trade liberalization and privatization.[3]

Finally, although business's importance for economic development is widely acknowledged, business actors in Latin America remain understudied (Ames et al. 2012, Karcher and Schneider 2012). Conducting research on business politics is a difficult and labor-intensive endeavor. Business's political engagement often takes place out of the public eye, and accessible, quantifiable indicators of business influence are rarely available (Karcher and Schneider 2012: 281).[4] By drawing on extensive fieldwork, hundreds of interviews, and documents unavailable outside the studied countries, this book advances our empirical knowledge and understanding of business's potentially far-reaching role in policymaking.

1.1 DIVERGENT REFORM EXPERIENCES

Argentina, Chile, and Bolivia stand out as leading Latin American cases of economic liberalization and market-oriented tax reform in the 1980s and 1990s. Value-added taxes (VATs) with broad bases and relatively high rates were established, and VAT revenue as a percentage of GDP reached European averages by the mid-1990s – around 7 percent of GDP.[5] Despite this success, each country experienced recurrent revenue needs during subsequent decades. Whereas consumption was heavily taxed, income and profits were under-taxed by roughly 6 percentage points of GDP in Chile and Argentina and 3 percentage points of GDP in Bolivia, given these countries' level of development (Perry et al. 2006: 96; Appendix 1.1). Accordingly, governments in each country contemplated "going where the money is" by increasing direct taxes on economic elites' income, profits, and/or wealth. Yet the reforms they enacted varied substantially.

Argentina enacted noteworthy direct tax policy reforms after currency stabilization in 1991. The country's corporate tax rate increased gradually from 20 percent to 35 percent, the highest in the region. Additional reforms closed loopholes and helped control corporate tax avoidance and evasion. Meanwhile, personal income tax modifications increased the burden on individuals in the top brackets. A modest national wealth tax was created and gradually increased. And the tax agency gained essentially unrestricted access to bank information. Bank information is critical for fighting tax evasion because it

[3] Exceptions include Weyland (1996), Eaton (2002), Mahon (2004), and Arce (2005).
[4] Accordingly, even scholars in the quantitative tradition recognize the need for intensive qualitative research (Ames et al. 2012).
[5] Consumption taxation in Chile and Bolivia exceeded expectations for countries of their GPD per capita (Appendix 1.1).

facilitates detection of assets that taxpayers have underreported or neglected to declare on their income tax returns.

In contrast, Chile and Bolivia enacted at most marginal direct tax policy reforms. In Chile, increasing the very low corporate tax rate was arguably one of the most important revenue-raising reforms, given the design of the country's integrated income tax system. Little progress was made on this key front; in 2009 Chile's 17 percent corporate tax rate remained the lowest in the region, aside from Paraguay. Meanwhile, reforms to close loopholes and fight evasion emphasized consumption taxes rather than income taxes, and tax agency access to bank information remained highly restricted. In Bolivia, legislating an individual income tax is critical for increasing taxation of economic elites. This tax was eliminated in 1986 because technocrats believed the tax agency was too weak to actually collect it, but tax agency capacity improved dramatically in the 1990s. A 2003 initiative to reinstate the income tax failed; to date, Bolivia still has no personal income tax. A wealth tax initiative was also defeated, and little progress was made in other direct tax policy areas like closing corporate tax loopholes.

These policy differences were not merely cosmetic. Argentina's reforms contributed to a notable increase in direct tax revenue. While direct tax collections held basically constant in Chile and Bolivia at averages of 4.3 percent and 2.3 percent, respectively, Argentine collections grew from less than 2 percent of GDP in 1992 to almost 6 percent of GDP in 2005 (Figure 1.1),[6] the largest increase in Latin America (Sabaini 2005: 32). Argentina enacted revenue-raising reforms in other tax policy areas as well. Thanks to these reforms, as well as improvements in tax administration, overall tax revenue in Argentina grew by almost 8 percent of GDP from 1995 to 2004, again the largest increase in Latin America; the region's average revenue increase during this period was only 2 percent of GDP (Sabaini 2005: 7). In fact, Argentina's tax revenue in 2008 was second in the region only to Brazil and exceeded expectations based on its level of development by a remarkable 5.5 percentage points of GDP (Jiménez et al. 2010: 26).[7]

This cross-national variation is striking, especially considering that Chile has been portrayed as a regional success case for progressive tax reform (Weyland 1997) and for development more broadly, whereas Argentina is often considered to have a weak state, volatile economic governance, and limited extractive capacity (Levitsky and Murillo 2005, Melo 2007, Kurtz 2013). Yet cross-national variation is not the only aspect of tax policy in Latin America that

[6] The dip corresponds to Argentina's 2001 economic crisis. Figure 1.1 shows revenue collected by the central state, before transfers to provinces.

[7] Direct tax revenue in Chile and Bolivia increased substantially after 2005, but gains resulted primarily from exogenous commodity booms affecting mineral exports (Appendix 1.2). Total tax revenue in Chile nevertheless remained almost 4 percentage points of GDP below expectations based on per capita GDP (PPP).

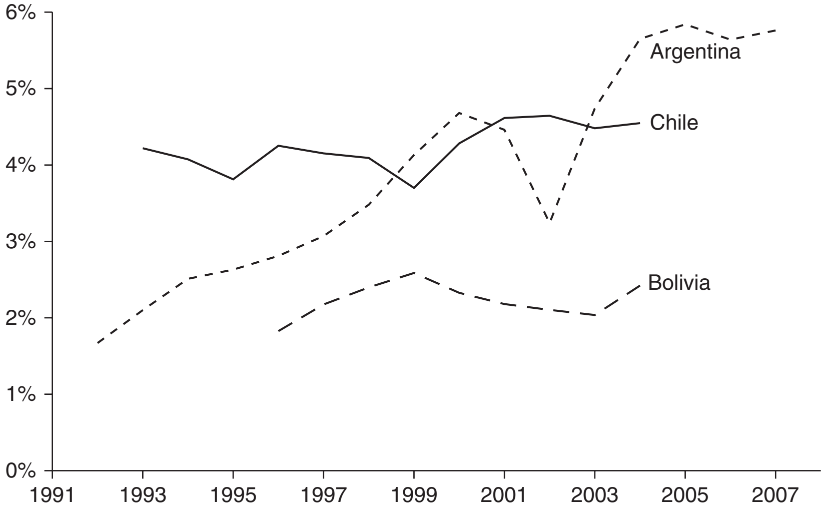

FIGURE 1.1. Direct Tax Revenue (% GDP).
Sources: SII 2009; SIN 2006; DNIAF 2012.

requires explanation. Outcomes also varied within countries, both across tax policy areas and over time. For example, despite Argentina's many successes, governments were not able to eliminate a costly income tax exemption for interest earnings that benefited upper-income individuals, and expanding tax agency access to bank information proved impossible until after the 2001 economic crisis. Further, whereas governments were able to repeatedly increase agricultural export taxes from 2001 through 2007, a 2008 tax increase had to be revoked due to sustained producers' protests. Turning to Bolivia, although efforts to tax domestic elites failed, the country dramatically increased taxation of foreign elites, namely multinational hydrocarbon firms.[8]

The range of policy variation across and within these Latin American countries poses challenges for several well-known theories of taxation (Table 1.1). Approaches treating direct taxation as a collective-action problem resolved through elite cohesion predict incorrect cross-national outcomes for the countries I examine. Economic elites were far more fragmented in Argentina than in Chile or Bolivia, yet Argentina legislated the most significant direct tax increases, contrary to the theoretical expectation. These collective-action approaches emphasize that organization and cohesion encourage elites to focus on shared long-term interests in fiscal stability and other benefits that strong tax capacity affords, thereby making elites more willing to pay direct

[8] See Appendix 1.2 on commodity taxation.

TABLE 1.1. *Theoretical Predictions and Latin American Anomalies*

Prediction	**Unexpected or Unexplained Outcomes***
Elite cohesion facilitates direct taxation (Weyland 1997, Lieberman 2003, Slater 2010)	Chile (1991–2009), Bolivia / *Argentina*
Capital mobility discourages corporate tax increases (e.g., Rodrik 1997, Williams and Collins 1997, Appel 2011, Swank 2006, Hart 2009)	Argentina (1990s)
Economic importance or wealth confers influence (e.g., Handley 2008, Winters 2011, Gilens 2012)	Argentina, esp. agro-export taxes (post-2002)
Public opinion trumps business interests on high-salience issues (e.g., Smith 2000, Culpepper 2011)[a]	Chile, esp. failed 2004 copper royalty initiative
Benefits for economic elites are necessary for increasing their taxes (e.g., Timmons 2005, 2010)	Argentina, esp. agro-export taxes (post-2002)
Instability discourages policymakers from increasing direct taxes[b] (Melo 2007 drawing on Spiller and Tommasi 2000, Levitsky and Murillo 2005)	Argentina, Bolivia (2003–04) / *Chile (1991–2009)*
Dire macroeconomic need facilitates direct tax increases[c]	Bolivia 2003–04

* Normal type indicates the cause is present but not the outcome; italics indicate the cause is absent but the outcome is present.

[a] See also Murillo (2009).

[b] Melo (2007) links instability to short time horizons and hence policymaker preferences for easily collected indirect taxes rather than direct taxes. Argentina has been plagued by instability – institutional, economic, and political – yet direct tax increases were more significant and had a greater cumulative effect than in Chile, its enviably stable neighbor. Likewise, policymakers proposed taxes on income and wealth in Bolivia during the early 2000s, a period of extreme political instability associated with radical threats to the status quo from mobilized popular sectors.

[c] This argument cannot explain variation across the two countries in this study that were afflicted with economic crises. Argentina legislated direct tax increases in the run-up to the 2001 crisis, but Bolivia's efforts to tax income and wealth failed despite perilous budget deficits.

taxes (Weyland 1997, Lieberman 2003). Yet this logic does not always operate; elites may or may not perceive strong incentives to accept tax increases independently of whether they are cohesive or fragmented. And when they do not perceive incentives to accept tax increases, I argue that cohesion is a source of power that enhances their ability to resist reform. This view agrees with earlier literature that emphasized the potential for cohesive elites to mount collective action *against* progressive reforms.

Explanations focusing on capital mobility as a determinant of direct taxation are incomplete. Many authors have argued that international capital mobility forces governments to compete for investment by reducing corporate taxes.[9] Yet governments increased corporate taxes in Argentina in the 1990s, despite high levels of capital mobility. And although outcomes in Chile agree with the capital-mobility prediction, I will argue that this variable plays at most a secondary role in the explanation. Capital mobility can be a key component of business's structural power, but tax competition arguments often fall short because they are not sensitive to the context specificity of structural power.

Innovative recent research on wealthy individuals and business, discussed further in Section 1.4, leaves important cases unexplained. Theories emphasizing the power of money, wealth, or a sector's economic importance overpredict elite influence in my cases. Argentine elites were often unable to thwart initiatives to tax their income and profits, and economically important sectors were occasionally subjected to heavy tax increases against their wishes. In contrast, theories emphasizing that issue salience and public opinion moderate business influence tend to underestimate economic elites' ability to resist taxation and redistribution. In many cases, tax policy decisions reflected the interests of economic elites much more closely than those of median or marginal voters, despite intense media coverage. Issue salience theories predict instead that when citizens pay attention to an issue, politicians pay attention to public opinion rather than to economic elites (Culpepper 2011: 6).

Arguments that the distribution of the tax burden mirrors the allocation of spending elaborated in literature on fiscal contracts and credible commitments are also incomplete. This perspective cannot account for variation across the cases in which left governments pursued redistributive taxation. In accord with this literature's expectation that states must provide benefits for economic elites in exchange for their tax dollars, Chile's left governments were able to legislate only minor direct tax increases to finance social spending for the poor. Yet left governments in Argentina were able to tax agricultural elites heavily after 2001, even though spending favored urban sectors. This anomaly arises because fiscal-bargaining approaches often do not adequately specify the sources of power that necessitate providing benefits to win elite acquiescence; elite opposition to tax increases is politically irrelevant if elites lack strong sources of power. Political resources in particular often receive insufficient attention.

Table 1.1 includes two additional perspectives that leave Latin American cases unexplained: arguments focusing on instability and on economic need.

One final plausible hypothesis proves unconvincing upon closer scrutiny: that tax increases are easier to legislate in countries with low compliance because economic elites ignore policy initiatives in anticipation that tax increases can be evaded. Contrary to common perceptions, direct-tax evasion in Chile is

9 Others disagree (Inclán et al. 2001, Gelleny and McCoy 2001, Basinger and Hallerberg 2004) or find mixed results (Wibbels and Arce 2003).

essentially as high as in Argentina: around 50 percent (Jiménez et al. 2010: 58, Jorratt 2009: 47–56). Arguments based on evasion levels therefore do not provide traction for explaining Argentina's more significant direct tax policy reforms. Furthermore, my interview data indicate that economic elites do care about statutory tax laws, irrespective of aggregate evasion levels. Tax increases are often designed in ways that curtail or eliminate opportunities for evasion – by implementing withholding regimes, by eliminating loopholes and exemptions, thereby simplifying the tax code and making it easier to detect evasion, or by strengthening the tax agency's auditing powers – for example, through access to information about taxpayers' bank accounts and financial transactions. During the studied period, experts considered tax agencies in Chile, Argentina, and Bolivia to be highly professional with similar levels of institutional capacity and technical competence (Bergman 2009: 76–83, Bolivian Finance Ministry-D 2007: interview),[10] and economic elites recognized that administrative improvements could lead to effective implementation of tax increases in the future, if not the immediate present. Moreover, the large firms and wealthy individuals who are most closely monitored by large-taxpayer units prefer to lower their tax burden through avoidance, which entails use of legal loopholes, rather than through evasion, which is illegal. Accordingly, reforms that close loopholes directly affect their tax burden.

This discussion highlights the need for "middle-range" theory that can account for broad tax policy variation without sacrificing explanatory leverage for parsimony or generality. The instrumental and structural power framework accomplishes this goal by examining multiple potential sources of power rather than focusing on a single causal factor and by recognizing that these sources of power will vary in kind and in strength across different contexts. Moreover, this framework clarifies the need to distinguish between actors' preferences and their ability to obtain the policies they prefer, which is a necessary step in accounting for several of the theoretical anomalies highlighted in Table 1.1. Although my analytical approach introduces complexity, this complexity is structured within a clear overarching conceptual framework that can be broadly applied in political economy beyond the specific issue of taxation.

1.2 Agenda Formulation and Proposal Outcomes

This book systematically examines the tax policymaking process, from agenda formulation to the fate of reform initiatives – how they are modified and whether they are enacted. Close attention to agenda formulation is imperative for assessing to what extent economic elites influence policy decisions because they may be able to shift the set of options under consideration

[10] High evasion reflected problems with tax legislation that made administration difficult and noncompliance equilibriums that are hard to alter even when tax administration follows best practices (Bergman 2009).

toward their own policy preferences. Influence over the agenda may in fact be much more significant than influence after the government has initiated a reform proposal.[11] Some authors are pessimistic about prospects for analyzing agenda formulation given the challenges it poses for empirical research (Smith 2000: 149, 159, Fuchs 2007: 59, Falkner 2009: 120, Culpepper and Reinke 2014: 12–13) – alternative reform options that policymakers consider but discard often are not publicly discussed. Baumgartner et al. (2009) tackle the agenda-formulation problem in U.S. politics through interviews with interest groups that reveal which policies they advocate, regardless of whether those issues are a matter of public debate or have entered the legislative agenda. My approach is similar, but I bring the policymakers who actually make decisions about reform initiatives to the forefront of analysis.[12] In-depth interviews conducted for this project with high-level executive-branch officials in charge of tax policy, including three former presidents and twelve former finance ministers, yielded extensive information about their actual policy preferences and the reasons that compelled them to rule out certain reform options.

Agenda formulation can be divided into five idealized stages, in which distinct considerations delineate increasingly restricted subsets of reform options (Figure 1.2). Although policymakers do not explicitly follow these steps, these stages serve as useful heuristics. The first stages involve technical and administrative considerations that shape how policymakers select appropriate tools to tax elites. I briefly discuss these considerations and then focus on the third and fourth stages, in which structural power and instrumental power – the main explanatory factors in this study – lead policymakers to rule out appropriate options. The third and fourth stages of agenda formulation constitute the primary emphasis of this book.

I treat the existing tax system and the relative importance of different types of income and assets as initial conditions that determine the set of relevant revenue-raising reforms. Under-tapped revenue bases are associated with different kinds of investments, wealth, or income flows in different countries and at different times. The nature of under-tapped revenue bases will not only vary across tax systems but may also shift with international economic trends, changes in national development models, or economic crisis. Together, the prevailing tax system and the structure of income and assets determine whether new taxes are needed, which exemptions or loopholes could be most lucratively eliminated, whether rates should be increased, and what additional powers would best help the tax agency fight evasion.[13]

[11] For excellent discussion on these points, see Hacker and Pierson (2002: 284).

[12] Baumgartner et al. (2009) interview only policymakers identified as advocates on issues advanced by interest groups. Their study is not designed to analyze policymakers' decision-making processes.

[13] Examples include broader access to bank information and authority to regulate transfer prices.