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Introduction: The Political Economy of Taxation in Latin America

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As the scandal of the Panama Papers – the leak of millions of records in 2016 from a law firm’s list of clients with shell companies in offshore tax heavens – revealed, individuals will go to great lengths to avoid taxation. In one case, a wealthy Mexican businessman had established a half-dozen offshore corporations to evade taxes, and, in the aggregate, his unpaid taxes on foreign accounts are estimated at around US\$100 million. The government of Costa Rica found at least 410 offshore companies set up by that country’s nationals. Overall, 22% of Latin America’s financial wealth is believed to be offshore, representing about US\$21 billion in foregone government revenue (Zuckman 2015). By most accounts, the leak revealed only the tip of the iceberg.

Although the prominence of the Panama Papers might imply that only economic elites engage in this behavior, resistance to paying taxes takes place at all levels. As former Guatemalan finance minister, Juan Alberto Fuentes Knight (2012, 22), laments about recent efforts to integrate business units of all sizes into the fiscal system: “It is well known that in practice, many companies keep three books: what they show to the tax authority that reflects extremely low profits or losses in order to pay low taxes; what they show to the banks to get loans, where they increase their profits to appear very successful; and the true accounts, that are secret.” These examples are emblematic of a long-standing challenge in the political economy of development: how to make taxation palatable.

In spite of this generalized animosity, however, there is an increasing consensus about the salutary consequences of taxation in terms of state capacity, government accountability, and economic development. For example, taxation is considered a fundamental source of resources that

can translate into state strength (Brautigam et al. 2008; Schneider 2012). It can generate links of accountability between citizens and rulers that make governments more responsive (Paler 2013; Tilly 2009). It can contribute to addressing inequality (de Ferranti et al. 2004; Mahon Jr. 2012) and promoting growth (Bird 2012; Canavire-Bacarreza et al. 2013), and, for these reasons, taxation is considered an essential tool for development (Evans 1995; Inter-American Development Bank 2013). Not surprisingly, calls by think tanks (e.g., Council of Foreign Relations 2014) and international organizations (e.g., CAF Banco de Desarrollo de América Latina 2012; Inter-American Development Bank 2013) for increasing fiscal extraction in the developing world have gained momentum in recent years.

Yet, in spite of the importance of taxation for these different areas, the attention on taxation has been largely concentrated in the design of tax systems (Santos de Souza 2013). Existing scholarship on the design of tax systems has been extensive at presenting a diagnostic of the state of taxation in the region and the nature of the reforms needed. For example, we know that extraction in Latin American countries is low compared to that of other countries at similar stages of development; that although taxation is generally low, there is considerable variation in fiscal extraction across countries; that the region's tax structures tend to favor indirect over direct taxes; and that evasion tends to be high compared to other places (OECD 2016). Given these considerations, common prescriptions have been the simplification of tax systems, the modernization of tax revenue administrations, and the elimination of exceptions and tax incentives – to name a few – in order to promote efficiency and minimize distortions in the economy.

This emphasis, although an important step in identifying the direction of reform, has come at the expense of the political factors associated with the successful adoption of reforms. With notable exceptions, most studies on fiscal policy in Latin America have tended to ignore the political underpinnings of taxation. This is a significant oversight because political conflicts are at the heart of the obstacles to reforming tax systems. As Wagner Faegri and Wise (2011, 246) have noted,

Despite the central role of taxation in economic development and growth, political economists have yet to develop a program of research that fully captures the politics of tax reform in emerging-market economies. Although legislative coalitions for economic reform have emerged in even the most contentious political environments, tax reform remains one of the more contested and understudied issues in Latin America.

This volume explores the role that political factors play in addressing the region's fiscal challenges. In particular, it tackles three main questions of the political economy of taxation in Latin America: What explains the region's low levels of taxation? What accounts for the region's tax structure? What explains differences across countries? By answering these questions, this book can inform efforts to address the region's taxation shortcomings.

In particular, the volume shows that commodity prices generate strong incentives for cycles of resource nationalism – encouraging certain governments to make poor tax decisions when entering into contracts – but also suggests that there is room for less structural factors to shape the levels and incidence of tax collection. For example, levels of taxation are shaped by the strength of economic elites, state capacity and compliance, and patterns of economic incorporation. Further, electoral rules, interest groups, and public opinion can play an important role in explaining differences in the tax structure, although there is significant crossover between groups because much of the region's low tax collection is related to the “missing share” of direct taxes. Differences in government's commitment to public spending, institutional strength, elite power, and electoral rules are helpful to account for considerable variation across countries, from Brazil's remarkable 34% at the top to Mexico's paltry 11% at the bottom.

Naturally, different courses of action often involve important trade-offs. A policy that makes taxes politically palatable may increase fiscal revenue but at the same time affect other important considerations in the design of tax systems, such as efficiency or equity. For example, while there is evidence that earmarking taxes reduces animosity toward increasing the tax burden (Flores-Macías 2015; 2018), these taxes might reduce efficiency in the tax system (Buchanan 1963; Goetz 1968). Yet, it is important to know the full spectrum of options and their tradeoffs to know what governments can draw on given each country's particular circumstances. Technically desirable courses of action can only go so far without the ability to generate the political conditions for their approval.

FROM RESOURCE BOOM TO FISCAL PINCH: THE RENEWED IMPORTANCE OF TAXATION

Paying taxes is perhaps one of the least popular activities for people across the world. In the United States, for example, public opinion surveys consistently show the percentage of people who believe their taxes are

too high at about 50%, whereas only 3% express that the tax burden is too low (Riffkin 2014). Attitudes toward taxes are similar in Latin America. In Chile, for example, 64% of respondents in a nationally representative survey suggested the tax burden should be lowered, compared to 9% who stated it should be increased (Fundación Jaime Guzmán 2011). In Mexico, only 5% of respondents in a similar survey suggested that taxes should be raised, whereas 64% stated they are too high (Centro de Estudios Sociales y de Opinión Pública 2013). These percentages have remained remarkably stable over time.

In spite of the continuous unpopularity of taxes, however, fiscal extraction has gained renewed interest in Latin America due to governments' newfound urgency to find sustainable sources of revenue. The commodity boom that began in 2003 and ended in 2014 became a major source of revenue for governments across the region (Monaldi 2014). The revenue windfall from exports of hydrocarbons, minerals, and agricultural products – often at record prices – greatly benefited government coffers. It allowed governments to improve budget balances and expand expenditures.¹ It also allowed them to increase official reserves and pursue countercyclical measures to cushion the impact of economic crises (Ardanaz et al. 2015, 4; IMF 2015).

However, commodity prices declined sharply in 2014, with many commodities by 2019 valued at less than half of their peaks during the decade-long boom. A prominent case is the price of oil, which stabilized at about \$40–50 per barrel by mid-2015 – less than half of its value a year earlier, and a fraction of its peak of \$143 in 2008.² This experience of oil – along with other hydrocarbons more generally – is not atypical; metals such as nickel, copper, silver, and gold – important exports for Andean countries such as Peru, Colombia, and Chile – have followed similar trends. The price of agricultural products such as soybeans – important for Argentina, Brazil, and Paraguay – have seen comparable decreases. Although current prices are not as low as those prevailing in the early 2000s before the onset of the boom, they have discouraged production, resulting in turn in lower revenue from royalties and taxes.

In Colombia, for example, where oil revenue represented a fifth of government revenue (Schipani 2015), oil production has plateaued after

¹ For example, governments across the region engaged in significant fiscal stimulus programs as a response to the 2008–2009 global economic recession.

² Constant prices in 2015 US dollars: www.macrotrends.net/1369/crude-oil-price-history-chart

a period of sustained growth between 2004 and 2013. In 2015, drilling declined by 25%, and the government is considering exempting oil companies from paying income taxes to address a decline in production, which is expected to drop below the government's target of 1,000 million of barrels per day (Willis 2015). In Mexico, where more than a third of government revenue comes from oil and the expected investment interest in the recently privatized oil industry has not materialized, production has steadily declined to its lowest point (1.9 million barrels per day [mb/d] in 2017) in at least two decades (Paraskova 2018) – a 24% decline since 2014 and 50% since its peak of 3.85 mb/d in 2004 (Flores-Macías 2016; Lajous 2014, 8). In both places there were high fiscal expectations riding on commodity prices before the panorama changed significantly.

A problem the region now faces is that increases in government spending based on temporary sources of revenue, while generally beneficial while they last, become difficult to roll back once the sources of revenue dry out (IMF 2015; World Bank 2016). People quickly get used to the higher levels of government expenditure, which become perceived as entitlements rather than temporary measures. In the aftermath of the global recession and the end of the commodity boom, governments have, by and large, failed to pare down the increases in spending since 2009 (IMF 2015). According to the International Monetary Fund (2015), spending-to-GDP ratios are about four percentage points of GDP higher on average today than their pre-crisis levels in 2007.

Due to the combination of reduced revenue from commodity exports and increased spending to cope with the global recession, fiscal balances across the region have deteriorated in spite of the sustained economic recovery following the crisis. Although several countries have adopted measures that have ameliorated the negative effects of the decline in commodity prices – including greater flexibility in the exchange rate and fiscal policy rules – the decline was so sudden and pronounced that it has had negative consequences across the board (Caceres and Gruss 2015, 51). As Figure 1.1 shows, the average fiscal balance as a share of GDP reached its lowest point in 2015 since the start of the boom. The difference is considerable when compared to the peak of the boom right before the 2008 crisis, when the region even experienced a surplus.

Although commodity prices behaved similarly for a number of goods, including metals, food, and oil (Figure 1.1), there is variation across countries as to the importance of the commodity boom for government coffers. As Figure 1.2 suggests, several countries leveraged the commodities boom to achieve surpluses between 2003 and 2012, including Argentina, Chile,

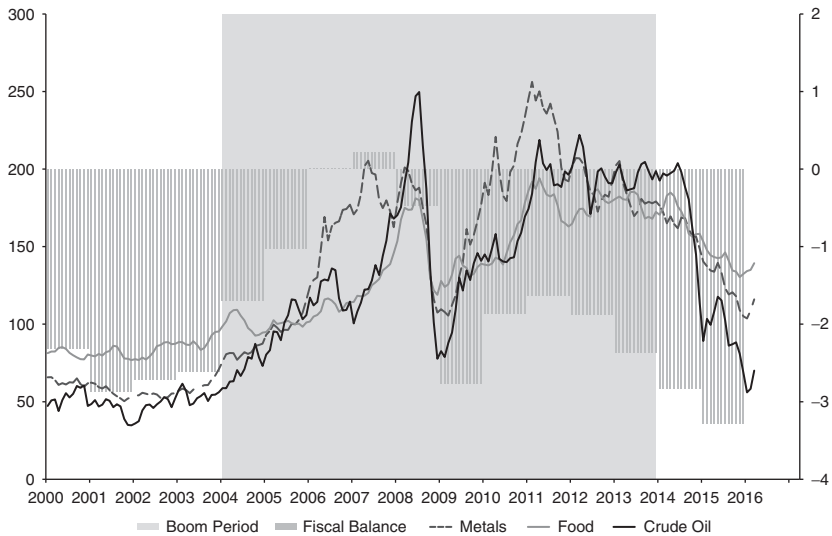


FIGURE 1.1 Commodity prices and Latin America's fiscal balance

NB: Left axis corresponds to the Indexes for Metals, Food, and Crude Oil (2005=100). Right axis corresponds to fiscal balance as a share of GDP. Fiscal Balance for 2015 is estimated with latest data available.

Source: Generated by the author with data from the IMF World Economic Outlook Database and CEPAL

Ecuador, Paraguay, and Peru. Others, such as Brazil, Colombia, Mexico, and Uruguay, did not achieve an average surplus during this period but improved their fiscal balances. However, all countries' bottom lines have suffered since the end of the boom. Whereas fiscal balances in Colombia, Nicaragua, and Peru have deteriorated by less than 1.2 percentage points of GDP since 2013, Argentina, Chile, and Ecuador have suffered decreases of more than 3.7 points. Although Venezuela is not included in Figure 1.2 because of lack of data, the impact of the end of the commodity boom is likely worst in that country, where oil generates more than 80% of the country's export revenue and about 45% of the government's revenue.³

Contrary to the favorable international outlook during the first decade of the twenty-first century, this bleak fiscal outlook for Latin America is taking place in the context of much less favorable international conditions. The global economy has decelerated, and perspectives for the

³ There has been little transparency in Venezuela's reporting of government data since Hugo Chávez's presidency.

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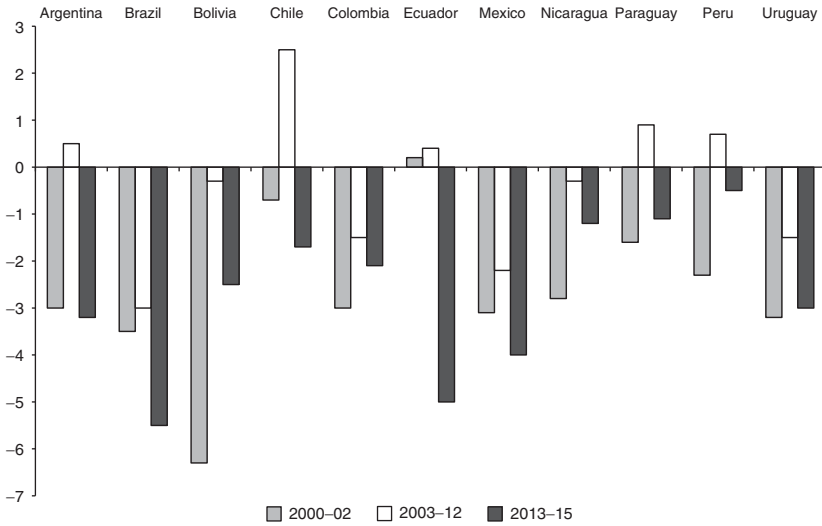


FIGURE 1.2 General government balance, selected countries (% of GDP)
 Source: Zhang (2016)

region's economic performance are much less rosy than over the previous decade due to tightening interest rates and higher borrowing costs. Growth in emerging economies is showing signs of less dynamism, with China and India struggling to maintain the spectacular rates of recent years. China's economy has grown at rates below 8% for five years in a row since 2013. The rates of 6.7% for 2016 and 2017 are the country's lowest since 1990 – far from its peak growth of 14% in 2007 (Magnier 2016; Hsu 2017). India's growth has also decelerated from a high of 10% in 2010 to 7.1% in 2016, and 6.8% in 2017 (BBC 2016; Times of India 2017). The decreased dynamism of these two countries has not only contributed to the end of the commodity boom, but also to a decrease in demand for Latin American exports more generally.

At the same time, the US Federal Reserve has begun to raise interest rates. This will lead to higher borrowing costs, translating into both a greater burden from servicing existing debt denominated in US dollars and an increased cost of borrowing in the future. These factors, along with US president Donald Trump's proclivity toward protectionism, are likely to further decelerate the global economy. In 2016, for example, the region contracted by 1% on average, with Brazil and Venezuela contracting by 3.5 and 8.3% respectively (World Bank 2016). In 2017, regional growth was a meager 0.9%. This leaves Latin America in the unenviable situation

of having to look for sources of revenue beyond those from natural resources at a time of international economic turbulence and low growth prospects.

Otherwise, the deteriorating fiscal situation will have important consequences for the region. In particular, spending cuts tend to affect the provision of public goods. This in turn negatively affects the most vulnerable sectors of society, who are not normally able to afford private alternatives. In Mexico, for example, the government has cut public spending by between 0.5% and 1.5% of GDP each year between 2015 and 2018 (Flores-Macías 2016; Graham 2017). In Brazil, a drastic provision limiting government spending for 20 years was approved in 2016 (Paraguassu and Marcello 2017).

Further, governments will become less able to address sudden crises by engaging in fiscal stimuli to soften the blow through countercyclical measures, as they did in 2008–2009. Instead, they are likely to find themselves faced with the conundrum of having to respond to a crisis but also having to put the fiscal house in order, which would likely worsen the crisis. This increases the chances that governments disregard existing fiscal rules in order to face short-term spending needs (IMF 2015). Fiscal buffers must be rebuilt before the next real crisis hits. Otherwise, the same tool used effectively during the 2008–2009 recession will not be available in the future. As the Latin American experience clearly shows, procyclical policies have been found to undermine growth (Ardanaz et al. 2015).

BEYOND COMMODITY BOOMS: LATIN AMERICA'S PENDING FISCAL ASSIGNMENTS

While the end of the commodity boom has brought the need for increased fiscal extraction to the fore of the region's policy agenda, it also serves as a reminder of unaddressed fiscal problems with which Latin American countries have struggled for decades. In particular, two main pending assignments are low levels of fiscal extraction and the tax structure's low contribution to addressing inequality.

Extraction Levels

First, while there has been some improvement over the last quarter century, the region's fiscal extraction remains lower than would be expected for its level of economic development. To be sure, the region has come

a long way compared to the period of large fiscal imbalances coupled with high inflation – which eroded the real value of tax revenue – that resulted from the debt crisis during the 1980s. At the time, countries across the region responded to the crisis by slashing public expenditures and adopting policies aimed at generating fiscal revenue.

Since then, governments have made important strides in modernizing their tax revenue administrations, simplifying tax systems, broadening tax bases, and reducing the number of exceptions and tax incentives (Prichard and Moore 2018; OECD 2016, 25). For example, many countries have expanded their tax systems to include all labor and capital income – including dividends – and introduced minimum taxes based on presumptive taxation along with controls for transfer prices (Tanzi 2008; OECD 2016, 25).

This trend is encouraging, but much remains to be done. Even with these important strides in tax collection, Latin American countries generally collect less than their potential. With a handful of notable exceptions, most countries' tax-to-GDP ratios range between 10 and 20%. As Figure 1.3 shows, this is not only lower than what most OECD countries collect, but also below the expected ratio for middle-income countries. The majority of the region's countries are a full five percentage points below their expected levels of taxation.

Yet, in spite of Latin America's generally low levels of taxation, there is variation across the region in terms of revenue generation. Whereas

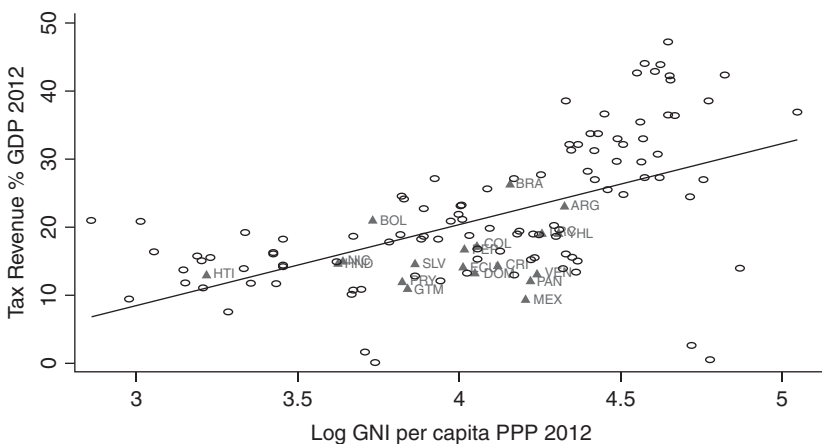


FIGURE 1.3 Tax-to-GDP ratio by income level (central government)
 Source: UNECLAC (2018), OECD(2018), and World Bank WDI (2018)

Guatemala and Mexico record extremely low levels of fiscal extraction with tax-to-GDP ratios of around 11%, Argentina and Brazil boast ratios comparable to those of many development nations – more than 30%. Other countries, including Bolivia, Honduras, Nicaragua, and Uruguay, have managed to collect tax ratios generally in line with expectations.

Inequality

In addition to the deficit in tax collection, another pending assignment is to generate tax systems that contribute meaningfully to addressing disparities in the region with the worst income inequality in the world. As Figure 1.4 shows, the wealthiest 10% of the income distribution concentrates 30% of income on average across countries in the region; by comparison, the average for the OECD is 24% of income. This concentration ranges from 40% of income in Brazil and 38% in Guatemala, on the higher end of the spectrum, to 20% in Uruguay and 23% in Venezuela, at the lower end. Conversely, the bottom 40% of the income distribution takes home 24% in Uruguay and 21% in Venezuela, compared to 15% in Brazil and 14% in Guatemala.

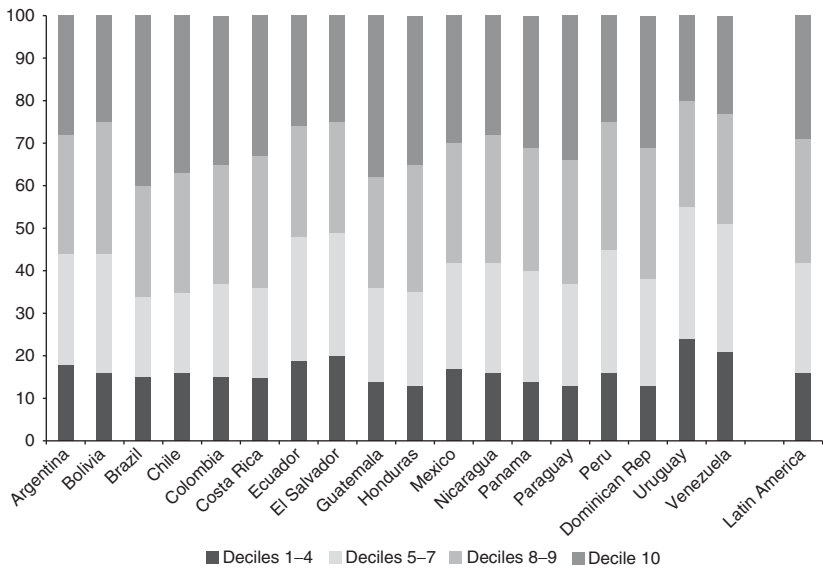


FIGURE 1.4 Latin America income share by decile group (%)
 Source: Hanni et al. 2015, with data from ECLAC. Data ca. 2012