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**Governance, taxes, and tax reform in Latin America**

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## Summary

In the 1980s, Latin American countries began to implement a set of tax reforms inspired in large part by the international financial institutions and ideas associated with the *Washington Consensus*. These reforms involved above all the simplification of tax structures and the removal of exemptions and special privileges; the replacement of trade taxes by value-added taxes; and an emphasis on improved tax administration. Although not fully implemented, these reforms have generally been useful. However, they have come at a price: other issues have been driven and kept off the tax policy agenda. The excluded issues include considerations of equity and redistribution; and a serious concern for governance questions – the interactions between tax policy and the legitimacy of governments and the policies they pursue. In a rather quieter way, many Latin American governments recently have initiated a series of “indigenous” tax reforms. These owe little to the support or urging of international financial institutions, are designed to deal with particular local problems, begin to address some of the more important political dimensions of tax reform, and have been modestly successful. These indigenous reforms provide a basis on which Latin American countries could build a more wide-ranging programme of tax reform tailored to regional and national circumstances. Such a programme could and should focus more on the political and governance dimensions of taxation and attempt to build something resembling national “social contracts” around issues of public revenue and expenditure.

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## Introduction

The 1990s have been a period of rapid fiscal adjustment in much of Latin America. There is a wealth of published analysis and evaluation of the expenditure cuts that contributed to adjustment, but far less material on the taxation side of the ledger. This report reviews the literature and ideas about tax reform in Latin American countries, with a specific focus on the impact of reform on poverty reduction, social inclusion and governance capacity.

Over the past two decades, tax reform in Latin American countries has been guided mostly by foreign experts and international financial institutions (IFIs), whose policy advice has been influenced by development policy practices as well as debates in industrial countries (Goode 1993; Stewart 2002). The IFIs have promoted a fairly homogenous set of tax reforms, often as a pre-requisite for the disbursement of loans and in concert with structural adjustment programmes. The reforms have been intended in particular to increase governments' tax takes (i.e. the proportion of GDP taken as tax revenue); to make tax systems more *neutral* in a microeconomic sense; and to make them more compatible with the demands for marketisation, trade integration and financial liberalisation (Perry and Herrera 1994; IDB 1996; CEPAL 1998; Shome 1999). More recent reforms have paid more attention to administrative and governance issues (Barbone *et al.* 1999) – although we will argue that a new conception of taxation and the social contract is necessary if such reforms are to be effective.

Although the reform packages have been basically similar from country to country, there have been significant variations in implementation and effectiveness. Domestic politics, socio-economic structures, and the institutional idiosyncrasies of individual countries have shaped the way the reform agenda has been translated into actual changes in the tax system. This paper deals especially with the political conditions that shape tax reforms, structures and performance in Latin America. It is organised in six main sections:

- In Section 1 we review the normative principles and theoretical approaches that underlie most Latin American taxation discussions and reform proposals.
- We survey the main characteristics of Latin American tax systems in Section 2, presenting first some stylised general characteristics, and then some of the variations and idiosyncrasies found in the region.
- The substance of post-1980s tax reform in Latin America is presented in Section 3. Framed by the previous theoretical and descriptive discussions, this section reviews the common features of the tax reform packages that have been prescribed in the region, and their underlying rationale. We also look at the role played by IFIs in the design and implementation of reform.
- In Section 4 we survey the literature that evaluates the tax reform process in Latin America in terms of the effectiveness of implementation and the impact on economic growth and poverty reduction.

- Section 5 summarises the most important innovations and institutional reforms in Latin American taxation. Particular attention is devoted to the identification of reform proposals that are inherently Latin American in the sense that they reflect structural, institutional and historical characteristics that are peculiar to Latin American countries. We also highlight the role that distributive and institution-building concerns played in reform design.
- Our conclusion in Section 6 identifies the main policy lessons.

## 1 Contrasting approaches to tax reform

Taxation is pivotal to development. It affects economic performance by altering individuals' incentives to work, save and consume and by influencing businesses' investment, location and hiring choices. It sets the potential for public sector performance by providing the resources required for the provision of essential public goods and services, for the funding of social insurance programmes and for the repayment of public debt.<sup>1</sup> Last but not least, taxation shapes the participation of civil society and the accountability of political institutions by engaging – or by failing to engage – voters, politicians and bureaucrats in the debate and oversight of government. Where this engagement is effective, state and society institutionalise an exchange of tax resources for representation and citizenship. This exchange lies at the heart of a social contract, and it is thin or absent for most people in Latin America.<sup>2</sup>

As we explain in Section 2, contemporary Latin American tax systems reflect the accumulated influence of different principles, theoretical approaches, political forces, private interests, and policy decisions. At different periods, governments pressed macroeconomic concerns, businesses worried about efficiency, progressive groups pushed for equity, and interest groups pushed their particular concerns. Some want taxation issues to be on the policy agenda, while others – especially those that pay less tax than they should – try to avoid and quash debate.

The consolidation of democracy in Latin America and the shift away from protected markets since the 1980s have placed a range of pressures on tax regimes. Democracy has unleashed new and vocal demands. The liberalisation of finance and trade has strengthened the pressures to harmonise tax systems internationally. Finally, rising public debt demands increases in revenue-raising capacity.

Responses to these pressures lead to various dilemmas, especially for Latin American countries. Dependence on foreign capital and vulnerability to short-run capital movements limit the options available to governments. Large populations of poor people and high income and wealth inequality limit the potential tax base. Researchers and policy-makers have tried to address these issues without replicating earlier mistakes. A more active tax policy may be part of a transparent and sustainable solution.

The approach to tax reform has been heavily influenced by several theoretical approaches. These are not specifically Latin American, but, in varying degrees, components of a shared set of international ideas, albeit one with a strong Anglophone flavouring. Each approach to tax reform derives from a different answer to the following question: *What should be the main concern when designing tax systems?* There is an enormous range of potential specific answers to that question. We find that, in the recent literature at least, there are four major approaches, each reducible to a single question:

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<sup>1</sup> The literature on the effects of taxation for economic development and government performance is abundant. Comprehensive reviews are presented in Newbery and Stern (1987); Gillis (1989); Bird and Oldman (1990); Bird (1992); Burgess and Stern (1993); and Tanzi and Zee (2000).

<sup>2</sup> There is a vast literature in political science and political sociology that looks at the impacts of taxation on state building and the legitimacy of political representation systems. The literature on the interactions between taxation and political development for developed societies is surveyed in Tilly (1992) and Campbell (1993). Moore (1998) and Moore and Rakner (2002) compile and review several pieces directly related to developing countries.

- Will the system be efficient and effective from the perspective of conventional micro-economics? (*The public economics approach*).
- Will the system be responsive to the needs of those concerned with macroeconomic management? (*The macroeconomic approach*).
- Is the system easy and cheap for government agencies to administer and taxpayers to use? (*The administrative approach*).
- What are the implications of the system for governability and political legitimacy? (*The political approach*).

**Table 1.1 Summary characteristics of alternative approaches to analysing taxation**

<b>Approach</b>	<b>Key concerns</b>	<b>Typical policy advice</b>
Public economics	Microeconomic efficiency; equity; optimal taxation	Tax structure should be neutral; zero tax on intermediate goods; benefit taxes and taxes on immobile tax bases should be assigned to local government; taxes on mobile tax bases should be assigned to central government
Macroeconomic	Short-term stability; Long-term accumulation	Aggregate tax take should stabilise public debt; tax structure should emphasise stable revenue flows rather than counter-cyclical fluctuations; tax structure should promote accumulation for long-term growth
Administrative	Administrative efficiency; effectiveness	Tax structure should be simple for both collectors and payers; tax administration should be professional and bureaucratic-rational
Political	Societal legitimacy; institutional capacity; political development	Tax reform requires approval from a variety of social actors; taxation should be clearly linked to expenditures and should improve equity; tax policy and administration should be transparent and accountable

The policy implications of these approaches often conflict with one another. As a result, it may be difficult to find proposals that lead to simultaneous progress on two or more of these criteria – or even, less ambitiously, that advance one set of objectives without compromising another. Poll taxes, for example, are flat taxes on all resident adults regardless of income, spending patterns or other socioeconomic characteristics. They were the fiscal basis of many early states; microeconomists judge them neutral with respect to economic activities; if variable, they offer significant advantages as instruments of macroeconomic adjustment; and they are administratively simple. However, the concept of a poll tax strongly violates norms of equity, not to mention current norms of political legitimacy. The British experience of introducing a poll tax in the 1980s serves as a warning to those who ignore one or more of the approaches to tax.<sup>3</sup> The following section describes the main concerns and policy implications of literature within each approach.

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<sup>3</sup> See Smith (1991) for a more detailed description and analysis of this experience.

## **1.1 The public economics approach**

Public finance economists emphasise the principles of (microeconomic) efficiency and equity. The notion of microeconomic efficiency – otherwise labelled as economic, allocative or Pareto efficiency – is foundational to modern economics. This approach begins from the proposition that, in the presence of well-functioning markets, taxes are intrinsically distortionary: even if they fund public goods, they have to be viewed as a necessary evil. They divert resources to the public sector and distort market operations. These distortions impose economic costs, which either are not appropriated by any economic agent or are appropriated by one agent to the detriment of others. Such costs are often referred to as deadweight, or welfare, losses. The efficiency principle enjoins policymakers to minimise such costs through the choice of an optimal level and structure of taxes, given certain revenue needs. This principle has spawned a wide literature on *optimal taxation*.

But surely this emphasis on *efficiency* is different from – and possibly opposed to, in both spirit and substance – a concern with *equity*? In fact, the optimal taxation literature has defined efficiency and equity together such that efficient tax systems are optimal in terms of production and consumption and are at the very least neutral in distributional terms across individuals. This concept of equity differs from explicitly normative and ethical efforts to shift wealth from the rich to the poor, but is consistent with the notion of an optimally efficient distribution of wealth. To frame equity in this sense, conventional tax analysis focuses on the question of how alternative taxing schemes distribute the burden of taxation and output reduction. This burden includes the deadweight loss imposed by the tax system as well as the value of real resources extracted by the state. Such a definition allows them to disaggregate the concept of equity into two dimensions: *horizontal* and *vertical equity*. A tax system is said to be horizontally equitable if it treats equals equally. Two persons with equal welfare before tax should have equal welfare after. The more general operational principal is neutrality: there should not be arbitrary distortions when one compares the tax incentives facing citizens participating in different economic activities. The same tax burdens should fall on butchers as well as bakers; enterprises that export and those that import; firms that produce shoes and firms that conduct market surveys; and families that eat tortillas and those that prefer rice.

The principle of vertical equity focuses on how the tax system treats persons of differing initial welfare levels. If two individuals have different welfare before tax is levied, those with higher welfare might be expected to contribute more.<sup>4</sup> Such a system is progressive, and taxing the poor more heavily than the rich is considered regressive. The concept of vertical equity approximates more closely to more normative approaches to equity and allows for calculations of an optimal tax regime given a desired distribution of wealth. Of course, the “desired distribution of wealth” calls for judgements about the relative benefits of extra income to the poor and the wealthy. The difficulty of making definitive

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<sup>4</sup> Income is one, but not the only, component of individual welfare.

judgements often leaves the public economics approach handicapped when it comes to vertical equity concerns. Most often, its proponents offer vertical neutrality – income or wealth distribution should at least be no worse after taxes than before.

Public economics theories essentially combine efficiency and equity principles by optimising tax structure with respect to a welfare function.<sup>5</sup> A thorough review of the evolving literature on taxation is beyond the scope of this survey; instead we will concentrate on reporting its most important results for Latin America.<sup>6</sup>

Much attention has been paid to the advisability of direct taxes (e.g. income taxes) versus indirect taxes (e.g. taxes on consumption). There seems to be a perception that income taxes should be preferred on equity grounds while consumption taxes should be preferred on efficiency grounds. However, it is unclear how far this assumption is valid in practice.<sup>7</sup> Optimal tax theory suggests that constant marginal income tax rates are neutral and also the most efficient in terms of after-tax income equality because they result in no disincentive to effort (Diamond and Mirrlees 1971).<sup>8</sup>

There is also consensus around the concept of neutrality in consumption taxes. Differential tax rates on final goods, promoted by some people on equity grounds, are a less efficient means to redistribute income than the use of direct payments to households (Atkison and Stiglitz 1980; Deaton and Stern 1986). Also, a zero rate on intermediate goods induces optimal consumption and production, implying that turnover taxes should be replaced by the Value Added Tax (VAT) or final sales taxes. Moreover, applying the principle of neutrality to international trade, viewed as a type of productive activity, implies that rates on imports and exports should also be set to zero. Taxes on such goods would create disincentives for domestically produced and consumed goods (Diamond and Mirrlees 1971).

An active subfield of the optimal tax literature has been the study of the assignment of tax bases and tax revenues among different levels of government in federal or non-unitary systems. Most of the formal work has been summarised and compiled in McLure (1983).<sup>9</sup> Three results emerged as particularly robust in the literature (Bird 1999):

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<sup>5</sup> Ramsey (1927) represents the first attempt to formalize this problem, often referred in the economic literature as the optimal tax problem.

<sup>6</sup> See Burgess and Stern (1993), Tanzi and Zee (1997, 2000), for recent surveys of the optimal tax theory. Heady (1993)'s survey is particularly useful due to its explicit presentation of both the strengths and weaknesses of optimal taxation as a guide to policy-making.

<sup>7</sup> The perception that income taxes entail higher welfare costs than taxing consumption stems from the observation by Atkison and Stiglitz that an income tax includes two broad components: a tax on labour income and a tax on savings or capital income (Atkison and Stiglitz 1980: chapter 14). Since labour income is shown to be equivalent to a tax on consumption in a dynamic environment, the income tax gives rise to an additional distortion on savings that is absent in the consumption tax. On the other hand, taxing consumption is inherently more regressive than taxing income, since it is administratively infeasible to effectively implement, on a large scale, graduated tax rates on consumption. Kaldor (1955) shows that, at least in theory, such a system is possible.

<sup>8</sup> Heady (1993) emphasised that the breadth and simplicity of constant marginal rates would have the additional advantage of improving administrative effectiveness.

<sup>9</sup> See McLure (1998) and Bird (1999) for a series of critiques and reviews to the original formulation of the optimal tax assignment. The optimal tax assignment problem has been part of the more general problem of allocating tax and spending functions in federal systems introduced in Oates (1972).

- (i) Lower levels of government should, as much as possible, rely on benefit taxation<sup>10</sup> of mobile units.
- (ii) To the extent that non-benefit taxes need to be employed on mobile economic units, perhaps for redistributive purposes, this should be done at higher levels of government.
- (iii) To the extent that local governments make use of non-benefit taxes, they should employ them on tax bases that are relatively immobile across local jurisdictions (e.g. property or land).

More recent work on optimal taxation has been focused on generalising previous results to environments where: (a) markets are not efficient due to the existence of imperfect forms of competition or to the existence of externalities; (b) financial assets (capital gains, inheritance, dividends, etc.) are considered more explicitly; and (c) the benefits of tax revenues in the form of an increased provision of public goods and transfers is integrated into the model.<sup>11</sup>

The key to the public economics approach is the notion of maximising a social welfare function that depends primarily, if not solely, on efficiency and equity. Other concerns are downplayed. But in most Latin American contexts, other (macroeconomic, administrative and political) considerations clearly deserve attention, and policy-makers have been wary of accepting the prescriptions of public economics without question. Nevertheless, the public economics approach offers useful tools for comparing tax reform options in a relatively rigorous way.

## **1.2 The macroeconomic approach**

The macroeconomic approach is broadly defined here as dealing with the impact of taxation on economic aggregates – the level and distribution of income, household savings, corporate investment, level of inflation and public debt. One can divide macroeconomic approaches into those that focus on the long term and those that deal with short run concerns.

The long term macroeconomic capacity of alternative tax systems has been mostly evaluated with respect to their impact on per capita income. This debate goes back to Adam Smith and is a central theme in the literature on development and growth. In the economic models popular in the 1950s and 1960s (Lewis 1954; Solow 1956) high levels of national savings were seen as the key to economic growth and development. Correspondingly, tax systems were expected to minimise or avoid taxing sectors and individuals with a high propensity to save and to tax heavily sectors that did not. Governments generally

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<sup>10</sup> Benefit taxes are taxes levied on the basis of the benefit principle, which states that each individual ought to pay taxes commensurate to the benefits he or she receives from the government. In contrast, non-benefit taxes are those based on the ability to pay principle, which states that the amount each taxpayer pays ought to be related to his or her level of economic well being (Slemrod and Bakija 1996: 52). Assuming that individual benefits can be correctly measured, benefit taxes do not affect the distribution of interpersonal welfare, and are considered neutral with respect to the equity principle.

<sup>11</sup> ‘Standard optimal tax theory does not provide a rationale for the high rates of taxation on alcohol, tobacco and petrol. If there is justification, it should be found either in terms of externalities that the consumption of such goods impose on other people or on the basis of particularistic behavior.’ (Heady 1993). ‘The primary reason why optimal tax theory has little to say about the overall level of burden is that much of this theory has been developed to suggest the optimal structure of taxes in a static context to raise a given level of revenues [ . . . ] To relax this assumption in a meaningful way, for purposes of normative policy prescription, would necessitate the explicit modelling of the benefits from public spending to be financed by tax revenues’ (Tanzi and Zee 2000).

interpreted this to mean squeezing tax out of rural populations, and for conservative regimes it justified regressive tax regimes. Recent work on endogenous growth theory has emphasised the contribution of equity to national economic performance and researchers are making a macroeconomic case for more progressive tax structures (Galor and Zeira 1993; Alesina and Rodrik 1994; Persson and Tabellini 1994; Benabou 1996).<sup>12</sup>

Short-run macroeconomic analysis has been concerned mostly with the ability of the tax system to respond to changes in the business cycle. Standard Keynesian theory suggests that passive tax policies might exacerbate business cycles, and that fiscal policy should be actively counter-cyclical. Governments should increase spending and lower taxes to help the economy out of recession. However, tax changes do not have an immediate effect on economic activity, and time lags may mean that activist tax policies exacerbate cycles rather than stabilise them. The consensus now is that tax policy should be designed to generate a stable flow of government revenue over economic cycles, even in the face of shocks to the tax base (Barro 1979). In the context of Latin America, inflationary booms and busts were among the most common shocks, and there has been a search for tax structures that are buoyant and stable in the face of inflation.

The analytical differences between the public economics approach and the macroeconomic approach have become less marked in recent years. Macroeconomic models have started to rely more consistently on microeconomic fundamentals and optimal taxation models have started to incorporate macroeconomic considerations, especially revenue capacity. Most of the current research on dynamic optimal tax theory, especially work related to the choice between systems based on consumption and on income taxes, has been motivated by macroeconomic concerns about income growth and inequality.<sup>13</sup> Despite this gradual convergence between the two approaches, they continue to produce divergent policy prescriptions on many occasions. And neither pays much attention to the administrative (or political) concerns to which we now turn.

### **1.3 The administrative approach**

The defining features of what we have termed the administrative approach are an emphasis on *efficiency* and *effectiveness*. In particular, the notion of efficiency focuses on the administrative costs incurred by the government in collecting and enforcing tax laws and the costs to taxpayers of complying with those laws.<sup>14</sup> The concept of effectiveness encompasses concerns that taxes should be predictable, transparent, and enforced by a fair judicial system. In practice, the administrative approach seeks technical solutions to administrative problems of raising a given amount of resources with a minimum of waste and effort.<sup>15</sup> The

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<sup>12</sup> However, the debate about the effects of equity remains open as an even more recent wave of empirical analysis suggests a positive effect of income inequality on economic growth (Forbes 2000; Li and Zou 1998).

<sup>13</sup> See Tanzi and Zee (1997) for a general review of the macroeconomic literature on the effects of taxes.

<sup>14</sup> See Bird (1992) for a general survey and Bagchi, Bird and Das Gupta (1995) for an overview with a particular economics focus.

<sup>15</sup> This approach has close affinities to the *good governance agenda* that emerged in the 1990s, with an emphasis on efficient, independent, accountable and open government (World Bank 1997).

most common analytic tool associated with the administrative approach is the notion of the *tax gap* – the difference between tax actually paid and the tax that should have been paid according to existing law and statutes. The tax gap comprises the sum of: tax evasion; tax arrears (taxes declared but not paid); the shortfall of taxes due to taxpayers misunderstanding of the tax laws; and any other forms of non-compliance.

Economists have extended the formal microeconomic analysis associated with the public economics approach to taxation to encompass the kinds of administrative costs estimated in tax gap analysis (Slemrod 1990; Slemrod and Yitzhaki 1996). They develop the concept of marginal efficiency cost of funds (MECF), which incorporates the cost of raising taxes into the estimate of the value of taxes to the government.<sup>16</sup> Thus, optimal taxes are those that raise a desired amount of revenues with the lowest MECF and the fewest distortions (neutrality), and promote the desired distribution of wealth (equity).

Some fairly straightforward advice emerges from this attention to administrative efficiency: administrative efficiency can be improved in the short-run by simplifying the tax structure. Simple tax structures are easier and cheaper for tax agencies to administer and for taxpayers to obey. Governments are advised to minimise the number and variety of tax exemptions, tax brackets, and specific incentives (subsidies, or tax expenditures).

Over the medium and long run, the administrative approach focuses more explicitly on effectiveness. This refers to the predictability and legality of taxes and the transparency and accountability of government (Bird 1992). Effective taxation, according to this view, is similar to any other public policy domain, in that it requires a professional, well-paid, autonomous, Weberian bureaucracy. This approach, as might be expected, has been of particular interest to people directly involved in and responsible for tax collection and the implementation of tax policy.

Some have argued for an independent and autonomous tax collecting authority. The declared objectives are to improve collection performance through (a) reducing “political interference” and (b) insulating the tax collection apparatus from the constraints of regular public service employment. In particular, elite entrance exams, better pay, and autonomous control of budgets and promotions have been proposed. Observers believe that these reforms can improve performance even in conditions of poor governance in other parts of the public administration, creating islands of efficiency that are insulated from external pressures (Geddes 1994). In recent years, independent revenue authorities have been created in several African and Latin America countries. The record of these newly created bureaucracies has been spotty, however. In Africa, the record has been particularly poor (Fjeldstad 2002),

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<sup>16</sup> They define MECF as the sum of the expected tax revenue and the expected leaked tax revenue divided by the sum of the expected tax revenue.

and in Latin America, even short term successes have eventually faded. New agencies, though initially autonomous and effective, slowly get infiltrated by the same powerful societal interests that capture other parts of government (Talierecio 2003).

It is clear from this record that reform of tax administration alone is not enough. Nobody would argue against encouraging professionalisation and other solutions that attempt to create a Weberian bureaucracy. Still, these reforms are unlikely to survive if there is no broader transformation of the way in which state and society interact. Even a bureaucratic and rational state will be unable to resist if powerful societal groups possess both political and economic power. In such situations, a more fundamental political change must occur for the state to enjoy sufficient capacity to both resist these groups and extract wealth.

#### **1.4 The political approach**

The political approach focuses on the inter-relationships between tax systems and political regimes. It is evident that taxation is not simply a technical question, and is inherently political. Proponents of what we term the political approach have a diversity of concerns. What they have in common is an emphasis on making political analysis central to the tax policy debate.<sup>17</sup>

Within this general category of political approaches to taxation, there are perhaps three main sub-approaches: *societal*, *institutional*, and *developmental*. The *societal* approach is political in the most straightforward and commonplace sense of the term: the study of particular processes and sequences with an emphasis on the clash of interests – “winners”, “losers” and the political tactics they employ. This approach usually focuses on the relative power of different social actors, and the ways in which taxation structures are the outcomes of social conflict. Both pluralist and Marxist political theory fall into this *societal* framework. According to (simplistic) Marxists, for example, the state is the executive committee of the dominant class and will use tax to promote their accumulation. Where the state acts against the short-term interests of elites, it is only a temporary effort to sustain long-term accumulation.

One implication of the societal sub-approach is that an efficient, equitable and effective tax reform has to be in the interests of important social actors. Reforms that produce such a tax system will not be politically feasible if distributional effects cannot be anticipated, *let alone* negotiated. Political feasibility thus depends on the elaboration of detailed analysis and discussion that predicts distributive outcomes. This allows ‘the limitation of risk so that affected groups will be willing to bear some additional – but predictably contained – costs’ (Ascher 1989: 414). Unfortunately, uncertainty about the outcome of reform can be sufficient to prevent reform (Rodrik and Fernandez 1991). Uncertainty may be so great that

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<sup>17</sup> Campbell (1993) reviews the political sociology literature. The political economy literature has addressed the determinants of tax reform in the more general context of the determinants of structural economic reforms. On top of trying to understand the timing of reforms, the literature has also explored the sequencing (why reforms are implemented simultaneously and some times one at a time) and the speed (why some countries go “cold turkey” while others apply each reform gradually) of reforms. Tommasi and Velasco (1996) review the literature.

only a serious crisis will make actors even consider reform (Drazen and Grilli 1993). Of course, different political institutions, such as centralisation or delegative democracy, can make it easier to impose reforms, but partisan coalitions and cooperation across branches and levels of government are necessary if reforms are to remain effective (O'Donnell 1994).

The interests of stakeholders influence the likelihood that reform will occur and the shape that it takes. Influential segments of society must be convinced that they should pay taxes – not an easy task in environments characterised by poor services and widespread corruption. Weaker segments of society may have less wealth to contribute, but it is equally important that they are included. They provide the mass support for reform, and can push it in a progressive direction. Bureaucratic cadres are also important. In situations where bureaucrats resist reform or fall back into corrupt behaviour, reforms are doomed. For example, independent revenue authorities, despite the best intentions, are often beset by these problems, as bureaucrats fail to reform their behaviour or simply use new institutions to recreate clientelist and corrupt practices.

Does this mean that nothing can be done if social forces do not favour tax reform? The institutional approach proposes a second best solution in the design of institutions. Institutions bound the interaction of social forces, define which interests will be represented, and can bias the outcome of social interaction. This powerful insight increased attention to the incentives built into institutions – such as presidential and parliamentary systems, electoral cycles, powerful central banks, finance ministries, autonomous revenue authorities, and decentralisation (Buchanan 1987; Besley and Case 2002).

Together, the societal and institutional approaches highlight the way actors come together in systems of political representation and are limited by state institutions, themselves the product of historical contexts. Thus, tax systems are understood to emerge from the pressures of social forces, but only after they have been filtered by formal and informal institutions of the state.

The third political sub-approach is the *political development* approach, which reverses the direction of causal enquiry. Instead of asking how existing political forces and institutions shape tax structures and tax reforms, the political development approach suggests that institutions of taxation affect the type and quality of governance, or the “political development” of particular countries (Brennan and Buchanan 1980; Bates 1989; Campbell 1993). From the perspective of the political development approach, taxation is as much a part of a social contract between state and society as it is a mechanism of financing government. A state with high levels of political legitimacy can depend on citizens’ quasi-voluntary compliance to contribute to public goods (quasi-voluntary because there is always some element of coercion). As a result, states that are accepted as legitimate are capable of securing resources to govern, to develop, and to compete in the international economic and political arena. The central question in taxation, therefore, is what the state must offer to earn citizen compliance. Citizens’ demands vary with regimes and over time, but they include some combination of accountable institutions, material benefits, and cultural meaning.

Much of the history of Western European state-building in the sixteenth to nineteenth centuries has been presented in terms of absolute monarchs securing resources to compete militarily in the international arena by gradually transferring power and material benefits to institutions that represented taxpayers (Tilly 1975, 1992). The terms of the social contract that emerged were the rights and services offered by the state in exchange for the revenues given by citizens.

In most cases in Latin America, the social contract is notably weak, and at best applies to only a narrow segment of society. Many citizens are trapped within clientelist relations, informality, social exclusion, and other forms of marginality. Even if they make tax contributions and benefit from public expenditure, there is no notion of a contract between citizen and state. They pay only what they have to pay to avoid being audited and caught. In part, this is a result of the socio-economic characteristics of the region: large inequalities, a narrow middle class, limited education, low participation, oligarchic agricultural elites, and a large informal sector. Political institutions bear some of the blame also, as they are incapable of penetrating society to extract resources, extend benefits to secure compliance, and generate the coalitions and embeddedness that create legitimacy and capacity.

The focus on state legitimacy and capacity highlights the connection between taxation and governance concerns. Statist political arguments emphasise the notion of taxation as an instrument and indicator of state institutional capacity. According to statist perspectives, states are institutions that seek to preserve themselves, maximise their power and expand their capacity. Taxation and tax administration are both measures of, and inputs into, these ends (Levi 1988: esp. 48–71). Political development involves the mobilisation of legitimacy and coercive capacity to generate tax compliance. In some analyses, nation-states are only considered institutionalised when their tax administration can extend territorial control and penetrate society. An extension of this logic is that those states that fail to enhance tax capacity are doomed to be swallowed, defeated, or simply retreat in the face of more institutionalised nation-states (Tilly 1992: esp. 63–5).

Liberal political arguments regard taxation slightly differently. For liberals, the growth of taxation is linked intrinsically to the rise of the liberal, democratic polity.<sup>18</sup> The expansion of state capacity, so important to the statist, is seen from the opposite side. Citizen contributions are only forthcoming if the state allows citizens representative institutions, competing jurisdictions, and ample room for free enterprise – all of which serve to check the expansion of state demands for tax.

Statists and liberals offer advice to governments that face powerful societal opposition to tax reform. For the state to overcome such opposition, statist institutions of capacity and liberal institutions of legitimacy must both be cultivated. One option is to target specific groups, especially marginalised groups, with benefits and privileged political access to act as a counterweight to entrenched opponents. Corporatist institutions, participatory institutions, and other representative arenas are examples. Also, the state can use its tax capacity to regulate and control opponents, for example by incorporating them into

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<sup>18</sup> For a summary, see Moore (2001).

the tax net where they have previously escaped – notably the informal sector, beneficiaries of off-shore income, and agricultural elites. These efforts to deliberately transform society through the use of state capacity and legitimacy are important parts of the kind of new relationships between state and society.

Less grandiose implications of this approach are simply to make more explicit links between the taxes citizens contribute and the benefits they receive. A few examples of such explicit linkage are user fees, earmarking, and oversight mechanisms. User fees are the most direct, though perhaps limited version, in which there is a direct relationship between fees paid by a citizen and the services that citizen receives. Earmarked taxes allow for the beneficiary of service to be a different citizen than the contributor, but it retains the explicit link between tax contributions and a particular type of expenditure. Earmarked taxes have been criticised because of the budgetary and macroeconomic policy constraints they place on governments (Bates 1989), but there may be a compromise. Setting low thresholds – for example, requiring that 10 per cent of a particular tax must be spent on education – can provide the legitimacy of an explicit link without constraining the government too tightly. Finally, citizens sense that they control or oversee the use of their taxes through mechanisms of transparency and accountability, especially through representative and even, participatory, institutions. Taxation, in sum, should be complemented by changes in institutions to link the distribution of tax revenues to benefits.

## **2 Latin American tax systems**

Early comprehensive assessments of the stylised facts and idiosyncrasies about Latin American and Caribbean (LAC) tax systems were compiled under the Joint Tax Programme of OAS, IDB and CEPAL (Joint Tax Programme 1965a, 1965b), and in Bird and Oldman (1968, 1990). Descriptions of Latin American tax policy and administration over the last two decades are presented in Shome (1992, 1995, 1999), IDB (1996, 1998a) and CEPAL (1998). Early studies on tax incidence in Latin America were compiled by Bird and De Wulf (1973), while IDB (1998a) reviews the current literature. Winkler (1994) explains how taxes are assigned between different levels of government, and how systems of fiscal transfers between them are designed and administered.

### **2.1 Stylised facts**

Latin American tax systems historically have been characterised by (a) a low average tax take; (b) a tax structure weighted towards indirect taxes with narrow tax bases, multiple rates and many exemptions; (c) a limited tax administration capacity; (d) a mild redistributive impact; and (e) a highly centralised tax assignment with tax revenues transferred to subnational governments in the form of ad-hoc negotiated block grants.

Table 2.1 summarises some of the common characteristics of Latin American tax systems, and displays it in comparative perspective. Average tax take, defined as the ratio of tax revenues in the gross domestic product (GDP), has been persistently smaller in Latin America than in OECD countries. Overall, the Latin American tax take has been fairly similar to the Asian average. However, if we exclude

South Asia from the Asian average, the remaining countries of Southeast and East Asia have a higher tax take than Latin America.<sup>19</sup> Other studies have shown that the tax take in several Latin American countries is below the expected figure once one takes into account their per capita income levels (IDB 1998b). In 1997, for instance, the average tax take in the region was 18 per cent while the average tax burden among countries with similar per capita incomes to the average was 24 per cent (IDB 1998b).

**Table 2.1 Tax burden and structure in LAC in comparative perspective**

(as % of GDP)

	Tax revenue		Direct		Domestic indirect		International trade	
	1975–85	1986–97	1975–85	1986–97	1975–85	1986–97	1975–85	1986–97
OECD	28.3	34.2	9.9	12.4	8.6	10.5	1.0	0.5
Asia (South and Southeast)	14.0	15.8	5.3	5.6	4.2	5.8	4.0	3.4
Africa	17.6	18.8	5.7	6.3	4.3	5.7	6.4	5.6
Latin America	14.9	15.2	3.8	3.4	5.0	5.5	3.1	2.2
Caribbean	23.3	22.4	6.4	.0	6.7	6.2	6.3	5.4

Source: IMF, Government Finance Statistics.

Notes:

1) Total tax revenue includes social security contributions.

2) After 1994, the "OECD" excludes Mexico.

3) "Income taxes" include taxes on capital gains and profits, but exclude property taxes.

Undertaxation of income, wealth and property has been a persistent and long recognised feature in Latin American tax systems. 'There are some countries which have been conspicuously unsuccessful in imposing taxes on the wealthy classes – chiefly, I think, the countries of Latin America' (Kaldor 1963: 414).<sup>20</sup> Not only are average income tax takes smaller than in the rest of the developing world, but the difference seems to be increasing. Between 1986 and 1997, for instance, the average income tax take in LAC amounted to less than 4 per cent of GDP, against 5.6 per cent in Asia and more than 6 per cent in African countries. Income taxes in Latin America have been characterised by multiple exemptions and incentives, high marginal tax rates, and lack of integration between personal and corporate sources (Rodriguez 1993; Shome 1995). They have been designed to give special treatment to the agricultural

<sup>19</sup> Between 1991 and 1995, the average tax burden in LA was 14.1 per cent of GDP in contrast to 16.8 per cent in Southeast Asian countries (IDB 1996).

<sup>20</sup> Also, see Jenkins, 'The property tax in Latin America has been frequently discussed but seldom implemented' (1995: 7).

sector and some specific industries (Shome 1999). Personal income tax rates have been highly progressive. Until the early 1990s, top marginal rates were higher than 50 per cent for many countries. Also, minimum levels of taxable income tended to be set at very high levels – e.g. from three times average per capita income in Brazil to up to 10 times in Ecuador, Nicaragua and Guatemala (IDB 1998b).

Indirect taxes, in the form of taxes on domestic and internationally traded goods and services, represent the bulk of Latin American tax revenues. The contribution of domestic taxes on consumption has increased in the last two decades. Value added taxes have become an important component of consumption taxes, compensating for poor income tax collections and decreasing taxes on foreign trade.<sup>21</sup>

Table 2.1 shows that the burden and structure of tax systems differs substantially between Latin American and Caribbean countries (CEPAL 1998). Average tax takes in the Caribbean are higher, rely more on taxation of foreign goods and services, and generally include more direct tax. Direct tax levies have been around seven per cent of GDP in Caribbean countries, versus less than four per cent in Latin America. The contrast between Central America and Caribbean countries is particularly interesting due to their geographical proximity and especially due to their similar small and open-economy nature.

The limited capacity of Latin American tax agencies is reflected in a large tax gap – the difference between what revenue authorities would collect if everyone paid the tax legally due and what is actually collected. The gap can be attributed to avoidance, evasion, and tax expenditures (CEPAL 1998).<sup>22</sup> Tax expenditures take the form of multiple tax exemptions, deductions and amnesties to particular sectors, regions, or taxpayers. In addition to sacrificing revenues, these tax expenditure provisions create opportunities for tax avoidance. Of particular worry is the ease with which citizens avoid income taxes, for example by shifting income off-shore. In such cases, avoidance – the switching of economic activity to non-taxed sectors – often borders on evasion, in which tax law is simply violated. Evasion is also possible because of defunct withholding schemes and non-existent auditing mechanisms, especially with respect to income tax (Jenkins 1995).

These policy shortcomings create challenges that revenue authorities are often unable to overcome. They lack trained and equipped professional staff with well-designed career plans. As a result, they are susceptible to corruption, and evasion is more likely (CIAT 1996). The high discretionary power of the executive branch to alter tax policy further compromises the administrative capacity of revenue authorities (Shome 1999).<sup>23</sup>

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<sup>21</sup> However, domestic taxes levied on intermediate stages of production are still an important component of indirect taxes in some countries of the region (Shome 1995).

<sup>22</sup> Income tax evasion and avoidance are quite large in Chile, where around 23 per cent of the potential tax base is not reported due to loopholes and evasion (Engel *et al.* 1997). VAT evasion is also substantial, averaging above 20 per cent of actual receipts (CEPAL 1998).

<sup>23</sup> For example, see Shome's comment, 'In many Latin American countries the tax code tends to become dotted with executive orders for administrative convenience [. . .] Upon inspection, it is remarkable how far the day-to-day interpretation and application sometimes are far from the original design and intent behind the law' (1999: 17).

Studies of the overall tax incidence in Latin America date back to Bird and De Wulf (1973).<sup>24</sup> Assessing the results of 29 studies relating to 17 Latin American countries, they concluded that in only four countries was the tax system (mildly) redistributive. Recent studies of tax incidence for specific Latin American countries have confirmed this position – Centro de Estudios Bonaerense (1997) for Argentina; Engel *et al.* (1997) for Chile; Santana and Rathe (1992) for the Dominican Republic; and Bahl *et al.* (1996) for Guatemala. These findings suggest scope for greater progressivity. However, progressive statutory income tax schedules do appear to result in progressive tax incidence. The two highest income deciles pay taxes that, as a proportion of their incomes, are several times higher than those of all other deciles, which are usually exempt. However, in no case is the share of income paid by the highest decile above 8 per cent of their total income, an actual tax burden substantially smaller than the average tax rate one would anticipate from the steep marginal tax rates found in the tax code. This result is a clear indication of the high levels of tax evasion among upper-income groups.

Historically, Latin American governments have been highly centralised. In the last two decades, several countries have devolved and begun to share important responsibilities subnational governments. For most of the region, however, the assignment of tax bases still reflects the former centralised governance pattern. Tax policy, administration and revenue collection are, for the most part, concentrated in the central government. As a result, Latin American subnational governments depend on intergovernmental transfers for their finances, and have little capacity to mobilise their own resources (Aghon and Casas 1999).

Intermediate levels of government, at state, provincial or department level and, especially, local governments, do a poor job in managing the few resources they control. Benefit taxes in the form of user-fees are usually under-exploited or set at levels insufficient to cover the long-term costs of the services provided (Lopez-Murphy 1995). Local government officials also lack the methods, autonomy, resources and political support to exploit effectively their main potential source of own revenues: the property tax (Lopez-Murphy 1995; Aghon and Casas 1999). Last but not least, the design of intergovernmental transfers undermines local tax effort. Most intergovernmental transfers take either the form of revenue-sharing or block grants, in which resources coming from the centre are not conditional on the compliance of subnational governments with any specific tax effort or tax capacity criteria (Winkler 1994).

## **2.2 The special features of Latin America**

Although the stylised facts presented above serve as a fair first approximation of Latin American tax systems, they hide important differences in tax take, tax structure and tax assignment within the region. These should be taken into account in the design and implementation of tax reform for particular countries or any subset of countries in the region.

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<sup>24</sup> For a better understanding of the state of the art on the incidence of taxes in developing countries, refer to Chu *et al.* (2000).

Latin American countries can be divided among low, medium and high collectors according to the size of their tax takes (Shome 1999). Summary figures are displayed in Table 2.2. Countries with persistent low tax takes include Paraguay, El Salvador and Guatemala. Argentina, Colombia and Mexico also present surprisingly low tax takes given their medium income sizes. Uruguay, Brazil, Chile, Costa Rica and Panama are in the high tax category.<sup>25</sup> These aggregate figures include social security contributions, which are particularly large in countries such as Brazil, Costa Rica and Uruguay but account for a more modest share in Chile, Bolivia and Paraguay (CEPAL 1998). The figures exclude revenues generated by state-owned oil companies, which represent an important source of government financing in Bolivia, Ecuador, Mexico, Venezuela, as does the copper industry to a lesser extent in Chile (Shome 1995; CEPAL 1998). The breadth and assignment of VAT is one source of heterogeneity across countries. In Argentina, and to large extent Chile, VAT is more broadly based than in Mexico and Colombia, where main articles in the basic consumption are zero-rated or exempted (IDB 1998b; Shome 1995). Brazil's dual VAT is unique: federal and state governments are granted the right to administer distinctive VAT bases.<sup>26</sup>

Looking at sub regions, average tax takes and tax structure does not seem to differ very much between Central and South America.<sup>27</sup> The only exception is the share of tax revenues derived from international trade. In Central America (excluding Mexico), international trade taxes have been above 2 and even 3 per cent of GDP in several countries. The average for the region during the 1990s was 3 per cent, double the figure for the average South American country in the same period and triple the Mexican figure.

Latin American countries also vary with respect to their degrees of fiscal decentralisation as well as with the nature of fiscal arrangements between central and subnational governments (Lopez-Murphy 1995). In Brazil, the most important source of tax revenue is a VAT assigned to the state level (ICMS) while in Chile all taxes are legislated, collected, and overseen by the central government. In countries like Brazil and Colombia, tax revenues have been decentralised more than expenditure functions. In Argentina, the opposite occurred, as more importance has been attached to the transfer of powers, especially in the areas of education and health care, while the financing of these services has been left to be defined later (Winkler 1994).

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<sup>25</sup> In Central America, Honduran and especially Nicaraguan data there is a striking high tax effort given level of income per capita. There is evidence that this is an artefact of consistently underestimated GDP, at least in the recent past, to bring advantages in debt forgiveness and exemptions from tariff limits. Such underestimations, obviously, inflate tax figures (We are indebted to Manuel Agosin of the IDB for this observation).

<sup>26</sup> See Varsano (2000) for a comprehensive overview of the Brazilian VAT system, a description of its problems and a proposed reform.

<sup>27</sup> See Stotsky and WoldeMariam (2002) for a recent overview of Central America tax systems

**Table 2.2 Tax take and structure for Latin American countries**

(As % of GDP) (Consolidated Central Government)

	Years	Total tax revenue	Other revenue	Income tax	Social security	Payroll tax	Domestic consumption tax	Trade tax
Dominican Republic	1990-98	14.1	1.4	2.5	0.6	0.0	4.8	6.0
Mexico	1990-98	13.1	1.8	4.7	1.8	0.0	8.4	0.9
Central America		15.5	3.9	2.9	4.2	0.0	6.1	3.0
Panama	1990-98	22.0	10.4	5.9	6.0	0.0	5.3	1.7
Nicaragua	1990-95	20.8	1.8	2.5	12.7	0.0	9.7	4.5
Costa Rica	1990-99	17.7	2.6	2.2	5.7	0.0	7.0	2.8
El Salvador	1990-99	10.5	0.7	2.7	0.0	0.0	5.7	1.7
Guatemala	1990-99	8.2	6.7	1.9	0.0	0.0	4.4	1.6
South America		15.2	3.2	3.9	2.6	0.2	6.1	1.5
Uruguay	1990-99	26.0	2.0	2.7	8.2	0.2	9.8	1.4
Brazil	1990-97	18.9	7.9	3.9	8.0	1.2	5.3	0.6
Chile	1990-99	18.7	3.9	4.0	1.5	0.0	10.3	2.1
Ecuador	1990-94	15.5	0.8	9.3	0.0	0.0	3.9	2.0
Venezuela	1990-99	14.8	4.7	8.6	0.8	0.0	3.8	1.7
Peru	1990-99	14.2	1.8	2.5	1.5	0.4	8.0	1.7
Argentina	1990-98	12.1	1.2	1.3	4.7	0.0	4.6	1.0
Bolivia	1990-99	11.9	4.4	0.9	1.6	0.0	6.9	1.1
Colombia	1990-99	10.9	1.7	4.6	0.0	0.0	4.9	1.3
Paraguay	1990-94	9.3	3.8	1.3	0.0	0.1	3.5	2.1

Source: Government Finance Statistics (IMF).

### 2.3 Origins

A number of factors help explain the level and structure of Latin American tax systems: (a) colonial heritage, (b) political institutions and regimes (c) economic structure, (d) income inequality, (e) easy access to non-tax revenue sources, and (f) previous development strategies.

There has been some speculation that the low tax takes of Latin American countries and their reliance on indirect taxation derive from the minor role played by war in the formation of their colonial states (Mahon 1997). Unlike European countries, colonial Latin American states were not built against

foreign invasion but to extract resources for the purposes of the metropolis. The legacy was difficulty in imposing direct forms of taxation, which required greater coercive capacity and legitimacy.<sup>28</sup>

Differences between the Caribbean and most of Latin America have also been attributed to historical factors traceable to differences between English and Spanish colonialism (Thirsk 1997; CEPAL 1998). In particular, legal institutions that facilitate more formal labour markets may explain, in part, the greater presence of income taxes in the Caribbean (Stotsky and Wolde-Mariam 2002). In addition, Caribbean countries generally inherited the parliamentary governing institutions of their colonizers, while most Latin American countries copied the presidential constitution of the United States.<sup>29</sup> In conditions of political division and polarisation, parliamentary systems offer the possibility of negotiating a compromise among elites in forming a government, while presidents must govern even if they face a legislature dominated by the opposition. There have been numerous studies on the impact of divided government in presidential systems, mostly focused on the states of the U.S.A. They generally suggest that, in such circumstances, it is more difficult to manage fiscal policy, especially to balance budgets (Alt and Lowry 1994). Similar dynamics are likely to be operating in Latin American presidential systems.

Regime types also left their mark. Latin American countries have mostly alternated between military and more democratic regimes. With the exception of Peru, most military regimes adopted regressive tax policies. Democratic regimes varied more, but have frequently been enmeshed in fiscal problems, including those created by inability to undertake fiscal reforms and the pressure of important constituencies for tax expenditure (Dornbusch and Edwards 1991; Cheibub 1998).

The origins of Latin American tax systems can also be traced to some of the general attributes of developing countries. A larger share of agriculture in total output and employment, a large informal sector, and limited technical capacity of the tax administration reduce the feasibility of direct taxes as reliable sources of revenue, and limit the total tax take (Tanzi and Zee 2000). In Latin America in particular, high income inequality concentrates both political and economic power, and undermines tax capacity and the political feasibility of direct taxation (Bird and Oldman 1968; Kaldor 1963; IDB 1998a). In addition, easy access to alternative government financing schemes such as foreign aid, subsidised loans, *seignorage* (printing money), and revenues from natural resources also play a role (Burgess and Stern 1993; Moore 1998).

Tax systems in Latin America also reflect development policy strategies. The policy of import substituting industrialisation, that was common until the early 1980s, implied high tariffs and tax incentives for selected growth-promoting sectors. The latter narrowed the corporate tax base and led to the creation of multiple corporate income tax rates (Perry and Herrera 1994; IDB 1996).

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<sup>28</sup> Gil Diaz (1990) observes that Mexico's earliest taxes were imposed by the last Spanish viceroys of the colonial period, who imposed a heavy burden on the colonies to try to fund Spanish military needs.

<sup>29</sup> Geographical factors such as the greater ease of tax enforcement at custom borders in small islands, along with cultural traditions and attitudes towards the public sector, are also mentioned (Stotsky and WoldeMariam 2002).

### **3 The approach to reform in Latin America**

#### **3.1 Common features and rationale**

Perhaps the one item remaining relatively unchallenged in the Washington consensus is a set of tax reforms. There is broad agreement on the desirability of these reforms, general overviews of which are provided in Bird (1992), IDB (1996), Jenkins (1995), Perry and Herrera (1994), Rodriguez (1993), Shome (1992, 1995, 1999), Tanzi (1992).

Before detailing this package of reforms, let us note that attempts to reform and harmonize Latin American tax regimes have occurred before, including in the early 1960s through programmes conducted jointly by the Organisation of American States (OAS), the Inter-American Development Bank (IDB), and the Economic Commission for Latin America (ECLAC). The Joint Tax Programme, as this effort was named, involved conferences on tax administration and fiscal policy, and a draft model tax code for Latin America (Joint Tax Programme 1965a; 1965b). Like current efforts, the aim was to stimulate similar reforms across the region. The key difference that defined the 1960s wave was a belief in ‘the superiority of direct taxes to indirect taxes, support for progressivity, and opposition to assignment or earmarking of tax revenue’ (Goode 1993: 38). These earlier reforms also centred more on tax policy design and less on tax administration.

In contrast, tax reforms that were initiated in the 1980s and continued through the 1990s gave unprecedented attention to tax administration, while shifting the substantive emphasis toward indirect tax systems levied on domestic sources. These more recent reforms have aimed to (a) make the tax structure more neutral; (b) simplify and streamline legal and administrative tax operations; (c) enhance revenue collections; and (d) promote the horizontal dimension of equity in tax systems over vertical equity. Based on these goals, tax reform proposals in the region have tended to include the following elements:

- (i) Implementation of broad-based and uniform VAT systems to replace taxes on foreign trade and cascading turnover taxes.
- (ii) Reduction of the highest statutory tax rates and simplification of the personal income tax system.
- (iii) Elimination of preferential treatment for particular sources of corporate income and particular economic sectors.
- (iv) Modernisation and strengthening of the institutions involved in tax administration.
- (v) Increased use of presumptive taxation on capital earnings based on the net or gross values of assets.
- (vi) Wider use of withholding taxes, current or advance payment systems, and adjustments for inflation, tax credits and debits in order to moderate the Olivera-Tanzi effect by which inflation erodes the value of taxes.

The change in the substance of tax reform proposals was the outcome of a major shift in normative principles and theoretical approaches to taxation as well as changing ideas about the development role of the state. More specifically, observers became extremely sceptical of the capacity of governments to use

tax policy to intentionally privilege certain sectors, alter the economic behaviour of labour or business, or redistribute wealth (Bird 1992). Instead, interventionist tax policy was replaced by a faith in markets and an emphasis on macroeconomic stability (Perry and Herrera 1994).

The new agenda emerged in the face of fiscal crisis, government incapacity, and stagnating economies. Observers were convinced that tax systems needed to raise more revenues, operate more simply and neutrally, and allow greater international economic integration (Tanzi 1992).<sup>30</sup> The immediate need was to deal with runaway inflation. Governments sought reforms that would both counteract it and keep revenues buoyant in the face of variable inflation rates (Jenkins 1995). In particular, inflation encouraged the increased use of withholding taxes, current/advance payment systems, adjustments for inflation, and tax credits or debits.

Some of the longer-term responses to economic stagnation, such as trade liberalisation, created difficulties for fiscal adjustment (Toye 2000). Decreasing trade tax revenues meant that countries would have to recover tax capacity where it had been lost or increase it where it never existed. This became even more necessary as international capital markets demanded fiscal surplus to guarantee creditworthiness (Perry and Herrera 1994). Governments were encouraged to increase domestic sources of indirect tax, in particular through VAT. Such taxes were written into trade agreements and have been attached as conditions to structural adjustment loans (Shome 1992).

The advice on direct taxes focused on broadening the base by eliminating incentives and exceptions while bringing down high marginal rates that encouraged avoidance and evasion.<sup>31</sup> These policies held out the promise of increasing overall revenues while also simplifying administration (Shome 1992) and being relatively neutral with respect to market signals (Tanzi 1992). Many assessments of previously progressive rate structures suggest they performed poorly (Bird 1992; Tanzi 1992). To the extent that governments and external observers did have a serious concern with equity issues, they tended to stress the value of increasing revenues to combat inflation, which was considered an “inflationary tax” that hit the poorest most directly (Cardoso 1992). Governments were advised that, having conquered inflation, they could seek progressivity on the expenditure side of the ledger (IDB 1998a). Only further down the line, when both of these had been achieved, could countries use tax structure to redistribute income. ‘At this stage, the pursuit of income redistribution should take a backstage position to revenue generation. In more normal times, governments if they wish, could bring this objective forward once again’ (Tanzi 1992).<sup>32</sup>

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<sup>30</sup> ‘Tax reforms or cuts in noninterest expenditure that leave a “primary surplus” large enough to meet the foreign obligations are highly desirable’ (Tanzi 1992: 646).

<sup>31</sup> Incentives took a variety of forms, including reduced rates, tax holidays, depreciation allowance schemes and other exemptions. Some of these were defensible from an optimal taxation perspective.

<sup>32</sup> ‘It is often argued that equity and even efficiency considerations require differential tax rates so that by advocating simplicity and, to a large extent, statutory proportionality, one abandons the objectives of equity and efficiency. The truth is that in most Latin American countries statutory progressivity for the income tax and highly differentiated rates for the other taxes (sales taxes, import duties) have not resulted in particularly equitable or efficient tax systems. What they have done is create many administrative headaches. And, of course, if they have reduced the ability of the government to raise tax levels, they may have hurt just the people they wanted to help through inflation, economic instability, and so forth’ (Tanzi 1992: 654).

International advisors increasingly emphasised the importance of a tax regime that could be implemented effectively in conditions of weak capacity in the taxation agencies (Shome 1999).<sup>33</sup> Simplified direct taxes and broad-based VAT were attractive for this reason. Weak tax administration in some Latin American countries has also been addressed with the creation of institutes for training tax officials, the adoption of wage incentives for tax administration personnel, the use of banking infrastructure to collect taxes, automated and systematised information systems, and the creation of special taxpayers units to monitor and collect taxes from the largest taxpayers (Rodriguez 1993; IDB 1996).

The 1990s have been a period of greater international economic integration, reflecting multilateral trade and financial liberalisation coupled with a regional trend towards deep trade integration (Barreix and Vilella 2003).<sup>34</sup> Some Latin American countries have made arrangements with developed country partners, such as Mexico's entrance into the North American Free Trade Agreement (NAFTA). These trends have brought tax harmonisation issues to the foreground. Even countries that have not yet signed agreements are looking forward to integrating with the US, their main trade partner, by incorporating into their tax structures elements of the 1986 and more recent US tax reforms.

International economic integration, in particular, raises the issue of international tax coordination. As more countries lower financial and trade barriers, the competition to secure international investment intensifies. Countries can be caught in a race to the bottom in which they cut taxes, especially on mobile capital, and are forced to cut spending (often social spending) or offer regressive tax holidays (Barreix and Vilella 2003). Attempts to coordinate tax rates across borders are difficult, yet they have been included in regional trade agreements such as Mercosur. Although more information is required, it seems clear that trade integration and tax harmonisation will have differential impacts depending on starting positions of different states. In small, Caribbean and Central American states, trade taxes have been the principal sources of revenue, and trade integration and tax harmonisation require significant changes in tax structure and revenue sources. In larger, and more developed Latin American countries, taxes on

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Latin America has a long history of attempting to make the tax structure more progressive. In doing so, it has severely limited its tax capacity, cutting down the resources the government can appropriate to promote its social agenda and maintain macroeconomic balance. It is much easier to achieve progressive spending than progressive taxation. After all, the top decile of the population uses neither the health nor basic education services provided by the government. Latin America has been able to collect more revenue from a relatively flat income tax than it used to collect from rapidly rising marginal tax rates. Value-added taxes with a broad base and few exceptions perform far better than those that exclude goods in order to make them more progressive. In this context, tax systems in the region would be far more progressive if collection were improved. The best way to improve the distributive power of fiscal policy would be to make tax administration more efficient and evasion more difficult by adopting simple tax structures' (IDB 1998a).

<sup>33</sup> It was in this context that Bird and Casanegra (1992) wrote that in 'developing countries tax administration is tax policy'. The same perception led Shome (1999) to observe that: 'Complex tax policy makes it difficult for tax administrators to interpret and implement their provisions. As a result they tend to simplify the tax code increasing, the distance from the original design and intent behind the law. Once the tax structure is simplified, it should be obvious that tax administrators would be justified to further simplify practices for administrative convenience only under extraordinary circumstances.'

<sup>34</sup> Latin America and the Caribbean have four main sub-regional economic blocs: Mercosur, the Andean Community, the Central American Common Market and the Caribbean Community. All are formally aimed at creating common markets or communities.

imports and exports provided revenues, but were more important for their protectionist functions. In these countries, eliminating trade taxes is more consequential for economic policy and structure than for fiscal reasons.

In short, the Latin American approach to tax reform over the last two decades has focused on improving administration; macroeconomic management; and making tax structures simpler, more neutral, and better suited to international economic integration. Equity and directing investment have mostly been left to other policy instruments.

### **3.2 Tax reform projects supported by international financial institutions**

These reforms took place while – and partly as a result of – the more active interest of international financial institutions (IFIs) in tax reform issues in developing countries. The World Bank started to incorporate tax policy and administration in its menu of fiscal adjustment advice. IMF technical assistance on taxation became more closely linked with its numerous adjustment and lending programmes, and it placed greater emphasis on administration and implementation. Regional development banks, such as the Inter-American Development Bank (IDB), also increased their financing of tax reform projects (Goode 1993).

Although the influence of IFIs in the design and implementation of tax reform projects in developing countries has been widely acknowledged, there have been few attempts to explicitly map their actions in Latin America. Their interventions in the region are usually referred to only indirectly in broader studies of developing countries as a whole (Goode 1993; Stewart 2002). Part of the difficulty in identifying and mapping tax activities has to do with diffuse and uncoordinated practices between and within departments and operational areas:

The process of identifying and mapping the tax reform activities of these institutions [IFIs] has not always been easy, as tax reform is one of the least visible aspects of their work. Many of the institutions have more than one department or operational area that works on tax reform or policy and sometimes there seems to have been little or no apparent communication between the different departments. A further difficulty is that tax reform is often conducted as technical assistance and even in the new climate of transparency, there is continued secrecy regarding technical assistance.

(Stewart 2002: 8)

Recently, efforts have been made to clarify who is doing what among the IFIs and to avoid repetition, share best practices, and coordinate technical assistance. In particular, an International Tax Dialogue (ITD) has been created among staff of the Tax Policy and Administration Thematic Group in the World Bank, the Fiscal Affairs Department in the IMF and the OECD Centre for Tax Policy and Administration (International Monetary Fund 2002b). It offers an incipient mechanism of cooperation, though it has yet to gain the buy-in of member governments.

Overall, the activities of international institutions with respect to tax reform can be classified into the following: (a) collecting and disseminating economic and tax system data; (b) making forecasts on economic progress, tax trends and tax revenues; (c) analysing tax policy issues and producing publications and working papers; (d) setting targets and recommendations for economic growth and tax reform; (e) creating, supervising and enforcing rules on economic and taxation issues, including treaties or conditions of membership; (f) maintaining fora for negotiations, such as committees on tax issues; (g) attaching tax reform conditions to financial assistance, loans or aid; and (h) providing technical assistance and education on tax (Stewart 2002).

Though the IFIs have replicated activities to some degree, some differences in their emphases in the region can be detected. The World Bank record in the 1990s is documented in Barbone *et al.* (1999). Of about 120 lending operations with components to strengthen some aspect of the tax system, 83 projects disbursed US\$3.8 billion on major tax or customs administration reform. Only in 37 of these loans were tax system reforms a component of a broader structural reform programme. Among the 83 projects in which tax features centrally, customs reform components were the most frequent. Tax administration reform predominated in technical assistance loans. Of special interest was the attention given to the VAT in tax structure. Concerns about tax administration were pre-eminent in 43 loans. This emphasis was justified in terms of revenue enhancement (40 per cent of cases), strengthening administrative institutions (37 per cent) and promoting macroeconomic stability and growth (28 per cent). Improving accountability and taxpayer education and services were major objectives in very few operations (7 per cent and 5 per cent respectively), and no project had a major focus on strengthening the voice or participation of taxpayers. There was a gradual shift in World Bank projects from Latin America, the Caribbean and Africa to Eastern Europe and Central Asia, and a decline in the total outlay from US\$5.1 billion during 1990–94 to US\$3.6 billion during 1995–1998. Of the 83 projects with a tax system component, 18 took place in Latin America and the Caribbean, amounting to 23 per cent of all projects and 26 per cent of the total loans disbursed.

The trend in the pattern of the IMF's tax activities was similar, though a few differences emerge. In the aftermath of the debt crisis in the region, the IMF influence on tax policy and administration was particularly strong. Closely linked to structural adjustment loans (SAF/ESAF), technical assistance relating to taxation was largely the remit of the Fiscal Affairs Department (FAD).<sup>35</sup> This department developed tax reform recommendations to be included in Letters of Intent signed by borrowers and produced regular

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<sup>35</sup> The ESAF was renamed the Poverty Reduction and Growth Facility in 1999 (IMF 2002b).

country reports that broadly surveyed tax policies (Stewart 2002). The impact of IMF policy advice was significant, as shown by a close match between tax elements in SAF/ESAF programmes and policies proposed and often implemented in the region (Abed *et al.* 1998).<sup>36</sup>

Like the World Bank and IMF, the InterAmerican Development Bank (IDB) has also been playing a role in tax policy in the region, in particular its (now abolished) Fiscal Division (IDB 1998b). Most of the IDB-funded programmes targeted tax administration reform, though some have included technical support for tax policies. Such tax policy programmes mostly aimed at simplifying tax systems and eliminating taxes with low yield. They were implemented in Peru, Ecuador and Suriname, among other countries. In tax administration, IDB-supported programmes have included: (a) the development of organisational and human resources, (b) revenue collection and information systems, (c) taxpayer compliance activities, and (d) developing taxpayer assistance facilities. Organisational and human resource programmes supported the creation of institutes for training tax officials, the adoption of wage incentives, and career plans for tax administration personnel.<sup>37</sup> Revenue collection programmes focused on developing reliable taxpayer identification systems, unifying taxpayer accounts, creating special units for larger taxpayers, and using the banking system for collection purposes. On compliance, partial audits focused on specific taxes with randomly selected contributors as a way to eliminate the discretion of tax officials. At the same time, programmes also touched on taxpayers' rights and created ombudsman units for taxpayers.

A few factors limited the impact of the IDB in the region. First, its specialised fiscal division was abolished in 2000. Second, the IDB's country project cycle explicitly links to political/election cycles to help borrower governments to control their own policy agendas. This emphasis on the shorter-term electoral cycle may increase an already high attention to issues of fiscal balance, and deflect attention from longer-run and politically sensitive issues such as poverty and inequality. Despite these constraints, the IDB demonstrated significant influence and identified a series of areas for future attention: (a) improving audit and control units; (b) designing tax harmonisation agreements; (c) devising effective legal sanctions against evasion; (d) modernising municipal tax administration; and (e) strengthening institutions responsible for internal and external monitoring and oversight.

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<sup>36</sup> 'Tax policy reforms [included in SAF/ESAF] programmes typically included key elements from the among the following measures: introducing or strengthening the broad-based consumption tax, notably a VAT, . . . setting import tariffs at a moderate low average rate, . . . reforming the structure of the personal income tax through the introduction of limited personal exemptions, a moderate top marginal tax rate, an overall exemption limit that excludes people with modest income, . . . an extensive use of final withholding' (Abed *et al.* 1998: 10).

<sup>37</sup> In an evaluation of Brazil's adoption of performance-based wages in tax collection, Kahn *et al.* (2001) observed a sharp increase in fine collections despite a decrease in the total number of auditors employed by the tax collection agency. The authors are quick to point, however, the dangers that such schemes may induce tax collectors in the promotion of extortionary practices.

## **4 Evaluating the reforms**

To evaluate the impact of the tax reforms during the decade, it is first necessary to note two things. First, not all reforms have been implemented, and second, the region continues to suffer serious developmental problems. Inflation rates fell to an average of 10 per cent – but recently have started to rise again. Economic growth has been mildly positive, but it has been limited to some countries and periods and has been far below the 5 per cent overall level observed in previous decades. Poverty and inequality persist, with extreme poverty in some countries and increasing inequality across the region. Tax reforms have clearly not been a silver bullet. On the other hand, reforms have not been implemented consistently and perhaps should not bear the blame.

### **4.1 Implementation**

The reforms in tax administration were implemented more consistently than others. A proliferation of programmes included staff training, establishing career structures, introducing modern information technology, and revising procedures and internal organisation. Collection of taxes through banks was adopted everywhere, as well as internal organisation by functions (collection, inspection, control, large taxpayer units, etc) instead of the traditional tax base by tax base approach (IDB 1997; Barreix and Villela 2003).

In the tax policy area, projects supported by IFIs achieved most between 1989 and 1994 (Lora and Panizza 2002). This early period saw two policies generally well implemented: (i) reducing taxes on foreign trade and (ii) reducing high marginal income tax rates for both individuals and businesses:

- Taxes on foreign trade, which in 1980 represented 30 per cent of all taxes in the average country in the region, were partially replaced by domestic taxes, to the point where trade taxes now generate only 17 per cent of revenue collected (IDB 1997). Trade taxes, however, still account for the largest share of tax revenue, and over half of the total tax take, in Eastern Caribbean countries (CEPAL 1999), and are the third major source of revenue in Central America (Stotsky and Wolde-Mariam 2002).
- Top marginal income tax rates fell from an average of 50 per cent in 1985–86 to 34 per cent in 1997, a rate of decline considerably more rapid than in the OECD. The same happened with corporate income taxes, which declined from an average of 37 per cent in 1986 to 28 per cent in 1997 (Shome 1999).

Other tax reform proposals, particularly those geared towards streamlining tax regimes, eliminating exemptions, or broadening the tax base were less consistently implemented. In fact, some studies have identified a “drift” in tax reform around the mid-1990s (Shome 1999; Barreix and Villela 2003). Many reforms were not implemented, reversed, or watered down. For example, though marginal rates on upper incomes came down, attempts to widen bases were blocked. In addition, turnover taxes that provided revenues for fiscal adjustment were left in place, even as they violated principles of microeconomic

efficiency. Some taxes were implemented but reversed in the face of external pressure, such as presumptive income taxes that were moderate revenue raisers but were opposed by foreign investors. Finally, even where income taxes were broadened, they were often crammed full of exemptions by powerful interests. In fact, personal exemptions increased from 1.29 per cent of GDP in 1991 to 1.36 per cent in 1997 (Shome 1999).

Reforms in the Brazilian indirect tax system in the 1990s offer a good example of a number of these trends. After its 1967 Constitutional Tax Reform, Brazil became one of the first countries to centre its consumption tax system on value-added taxes. Nevertheless, Brazil's VAT grew increasingly complex with a narrow base, several exempted goods, and multiple rates. Reliance on turnover and other cascading forms of taxation have also started to increase. Successive proposals to replace cascading and turnover taxes by a broader and more uniform VAT have been dismissed.

Several factors may explain inconsistent implementation. In the Brazilian example, a number of studies have highlighted the role of fiscally-strapped subnational governments that defend their few tax bases (Werneck 2000; Lledo 2001). More generally, reforms faced stumbling blocks at multiple veto points, including subnational governments and also opposition parties, fragmented legislatures, and slowly moving judiciaries. As could be expected, international actors and powerful local interests also resisted attempts to tax their income and wealth. Work continues on political obstacles to reform. In particular, policymakers are exploring what are “politically” as opposed to “economically” optimal reforms. Like optimal tax theory that takes into account administrative costs in assessing reforms, political optimality can assess reforms once veto players and institutional constraints are taken into account. Any such exercise must necessarily consider the impact of reforms.

## **4.2 Impacts**

The degree and direction of reform impacts depends in part on whose study one believes. For some commentators, reforms are associated with growth and stability. For a sample of 17 Latin American countries, Escaith and Morley (2001) found that tax reforms had a positive and significant impact on economic growth, and the IDB calculated a 0.2 percentage point increase in growth in reforming countries (IDB 1997). The latter study also found a 15 per cent reduction in the volatility of the fiscal deficit and a slight improvement in income distribution.

In contrast to these relatively positive evaluations, Behrman *et al.* (2000) and Morley (2000) concluded that tax reforms widened wage inequality in particular. Marginal tax rates were lowered for higher income segments and businesses while value-added taxes hit consumption in particularly regressive ways. Tax exemptions for basic goods were eliminated, and taxes on luxury consumption were lowered. In addition, the elimination of special incentives for import-substituting industries and high job-creation businesses or activities hit mostly those who depended on wage labour.

## **5 Latin American contributions: policy innovations and institutional reforms**

The strong influence of IFIs on the nature and substance of tax reform projects during the late 1980s and most of the 1990s has not prevented Latin American governments from designing and implementing their own “indigenous” tax reforms. Regional government intervention was important for three important reasons. These indigenous reforms were a reaction to institutional and structural problems that were to some degree inherently Latin American. They frequently have addressed issues left untouched by IFI-inspired tax reform projects, especially the progressivity of tax regimes and the accountability of people involved in tax policy design and administration. And they have been innovative, involving changes in tax policy and institutions that have not yet been tried in most industrial countries.

Particular challenges facing Latin American governments made the region a likely site for new experiments in tax policy and tax institutions (Tanzi 2000). Chief among the obstacles were (a) vast structural inequality and a related inability or unwillingness to exploit traditional forms of direct taxation such as those on income and property, (b) administrative difficulties of taxing a large informal sector, (c) highly inflationary environments, (d) strong pressure for additional tax revenues for fiscal adjustment purposes, and (e) weak social contracts and institutions of governance. These attributes, while specifically Latin American, also afflict other developing countries, and even some developed ones. As a result, disseminating these innovations serves as a useful complement to current conventional thinking on tax.

### **5.1 Tax policies**

The first set of innovations employed tax policy changes to resolve specific problems. Six have received coverage in the tax literature and will be addressed below: (a) the taxation of gross assets, (b) simplified taxation schemes levied on small firms, (c) the taxation of land value improvements (land value capture), (d) the taxation of bank account transactions, (e) the (implicit) taxation of foreign capital inflows, and (f) environmental taxation.

#### **5.1.1 Gross asset taxes**

A tax on the gross assets of enterprises and individuals that engage in business activities was first adopted in Mexico in 1988 and subsequently introduced in Argentina, Costa Rica, Guatemala and Venezuela (Tanzi 2000). Sadka and Tanzi (1992) have conducted a comprehensive analysis of the tax on gross assets, its origins and properties. According to them ‘there have been two basic reasons for the introduction of this tax in Latin America: first, the need for additional revenue in countries undergoing major adjustment programmes; second, the realisation that traditional taxes on the income of enterprises do not fare well in situations of substantial inflation’ (Sadka and Tanzi 1992: 1).

A critical element in the design of gross asset tax is the choice of tax base and method used in its valuation.<sup>38</sup> The gross asset tax is generally imposed on a taxpayer's gross business assets, which includes both current and long-term assets. Current assets may include cash, securities and inventories, while long-term assets comprise mostly land and other fixed assets. The "gross" denomination stems from the inclusion of debt-financed assets in the tax base as opposed to net asset taxes levied only on equity financed assets.<sup>39</sup> In administrative and compliance terms, this base has proved appropriate to an inflationary environment. High inflation allows companies to convert real positive profits, via nominal interest rate deductions, into reported losses for tax purposes. Tax avoidance is compounded as those losses may be carried on to the future, reducing a company's net worth and tax liabilities.<sup>40</sup> The gross asset tax eliminates this problem by including payments on debt principal and interest.

The advantages of a tax on gross assets go beyond their administrative effectiveness in tackling tax avoidance in inflationary environments. Sadka and Tanzi argue that gross assets may be a better proxy of the *normal* or *average* income flow generated by an individual or firm than the actual individual or corporate income reported yearly for tax purposes.<sup>41</sup> The presumptive and distinctive nature of the gross asset tax may also lead it to function in an equitable way. Standard forms of capital or corporate taxation are levied on actual income. This creates disincentives to work and save, generating deadweight losses.<sup>42</sup> Taxation on gross assets creates incentives for their owners to use them productively, hopefully to the general social advantage. More important, the capacity to avoid tax through stated losses associated with inflation is highly dependent on asset value, thus largely benefiting the wealthy. The gross asset tax can also be made more progressive by exempting small taxpayers.

Whether the gross asset tax should be implemented in Latin America as a minimum income tax, as a complement to it, or as a replacement for tax on income from capital will depend on the effectiveness of other taxes. Also, it will depend on the ability of Latin American governments to agree tax treaties with industrial countries in which a tax on gross assets could be accepted as a final tax on actual income. Unless such treaties are signed, firms investing in the region would not be entitled to tax credits against foreign taxes, and would be double taxed in those countries that levied gross asset taxes.

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<sup>38</sup> See Krelove and Stotsky (1995) for a succinct exposition of issues involving the design of different forms of asset taxation.

<sup>39</sup> The neutrality of gross asset taxes regarding corporate financing decisions is usually suggested as another potential advantage of this form of asset taxation (Krelove and Stotsky 1995; Sadka and Tanzi 1992). The lack of liquidity in security markets and the dominance of debt as the main source of corporate finance in Latin America emerge as more practical reasons.

<sup>40</sup> Adjusting assets by smaller inflation indexes than those used on the liability side is a possible and more explicit way. See Sadka (1991) for a more complete treatment of distortions imposed on corporate balance sheets in high inflationary environments.

<sup>41</sup> 'Indeed, economic theory suggests that the market value of the firm's assets is equal to the net present value of the future (after tax) cash flows generated by these assets. That is, the market value of the assets reflects more the high "true" profits to be generated by them, rather than the low profits or even losses reported for tax purposes' (Sadka and Tanzi 1992: 9).

<sup>42</sup> Unless they are exempted, a tax on gross assets may not alleviate poverty if initial endowments for those in the bottom of the actual income distribution are so small that they cannot rise above the poverty line even when a maximum effort is exerted.

The gross asset tax has proved particularly successful in Mexico even as standard capital income taxes or taxes on net worth exhibited substantial declines in other Latin American countries during the 1990s (Shome 1999). The Mexican tax base included all types of corporate assets, adjusted for inflation, with no deduction allowed for debt (thus its gross nature). This base was taxed at a rate of 2 per cent, was allowable against the corporate income tax (minimum income tax), and exempted financial institutions and small taxpayers (Thirsk 1997: 318). In light of the apparent virtues of the gross asset tax and the challenges in the design and valuation of its base, future work should be devoted to examining its administrative and political feasibility. Studies of the Mexican case should prove illuminating.

### **5.1.2 Taxation of small firms**

Over the last two decades, several Latin American countries have introduced simplified taxation schemes for small firms. Costa Rica, Dominican Republic, Guatemala, Mexico, Nicaragua, and Paraguay have implemented presumptive taxes for small taxpayers that (a) are levied on gross corporate revenues and (b) substitute either for VAT or income tax. Other Latin American countries such as Argentina, Bolivia, Brazil and Peru went further by creating a unique tax levied on small enterprises that replaces more than one of the major taxes (VAT, income, and social security taxes) (Tanzi 2000).

Such schemes were designed to reduce the compliance costs of small enterprises, which often lack the economies of scale and the technical capacity to assess and fulfil their tax liabilities under the conventional tax system. In particular, the gross revenue tax base entails less valuation problems than standard taxes on corporate income and even presumptive income taxes on assets. The simplicity of such a tax has helped reduce the costs of monitoring and collecting revenue from small firms, which have usually been large relative to the revenue potential. Another objective of these new forms of tax was to lower the attractions of operating in the informal sector.

Argentina's *Monotributo* and Brazil's *Simples* are recent examples of simplified taxes aimed at replacing several taxes.<sup>43</sup> A study conducted by Brazil's Internal Revenue Service tracked a group of small enterprises which were active in 1996 and which in 1997 opted for the *Simples* (Brazil, Secretariat of Federal Revenues 2000). Initial estimates revealed a reduction of 90 million Reals in the costs involved in receiving and processing their tax files. The same set of firms has created 500,000 new jobs – perhaps most importantly, these are now in the formal sector.

### **5.1.3 Land value capture**

The extremely unequal distribution of property in Latin America has always made both ownership and taxation contentious. However, in recent years some Latin American countries have started to discuss the implementation of a particular type of tax on land, commonly referred in the literature as land value

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<sup>43</sup> Brazil's *Simples* was implemented in 1996 with Argentina's *Monotributo* introduced two years later.

capture (*recuperacion de plusvalias* in Spanish). Land value capture corresponds to the taxation of land value increments that result from direct or indirect public action (e.g. public infrastructure investments).<sup>44</sup>

The taxation of land value increments goes back to the 1920s in countries such as Brazil and Colombia (Smolka and Furtado 2002). In its recent reincarnation, the debate has been centred on the taxation of urban property. Large Latin American cities such as Sao Paulo, Santiago and Bogota have started to implement or reinforce the use of land value capture mechanisms (Smolka and Furtado 2001). The city of Mexicali, capital of the Mexican state of Baja California, successfully replaced the traditional property tax, based on the combined value of land and buildings, by a tax exclusively on land value (Perlo 1999).

The growing popularity of land value capture in Latin America has less to do with its long-recognised efficiency and equity properties than with the increasing fiscal and political pressures for revenue mobilisation at the local level.<sup>45</sup> Fiscal and administrative decentralisation has given urban administrations more spending responsibilities, and democratisation has increased the demands placed on them. As a result, they have looked for revenue sources beyond historically ineffective property taxes (Smolka and Furtado 2002).

The degree of progressivity of such taxes depends mostly on the pattern of use of the revenues collected. If they are earmarked only for the contributing community, they may increase spatial socio-economic disparities. If, however, jurisdictions are able to shift revenues from areas with high value public investment to areas that require greater public infrastructure, the potential for progressivity is significant (Furtado 2000).

#### **5.1.4 Bank debit taxes**

A tax on banking transactions, mainly on debits, was originally introduced in Argentina in 1983. It was reintroduced there in 1988 and 2001, and implemented in Peru (1989), Brazil (1994 and 1997), Venezuela (1994 and 1998), Colombia (1998), and Ecuador (1999).

Bank debit taxes (BDTs) are a subset of financial transaction taxes, which are taxes levied on each instance of specified banking, equity, currency, securities, or other financial dealings. Bank debit taxes, in particular, are levied on withdrawals from or other debits to bank accounts, generally including the clearance of cheques, cash withdrawals, payment of loan proceeds, withdrawals through ATMs and charges to bank-issued credit cards (Coelho *et al.* 2001).

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<sup>44</sup> Land value capture can also be achieved through non-fiscal instruments such as the private beneficiary undertaking on-site improvements that benefits other community residents.

<sup>45</sup> The equity and efficiency properties of land value capture have been first advocated by the nineteenth century economist Henry George. See Brown (1997) for a recent compilation of Henry George's original insights. Even though there has been some debate on the generality of Henry George's propositions, the current consensus is that, if properly designed, a land tax is always efficient and equitable. The current debate has been centred on the administrative effectiveness of optimal land taxes (Netzer 1998).

As was the case with other tax policy innovations, governments' urgent revenue needs have been the major reason for the adoption of BDTs in Latin America.<sup>46</sup> The tax has also proved to be very popular and easy to administer given the consolidated and satisfactory role of banks as collection agents (Tanzi 2000). Such advantages, along with their ability to target the informal sector and to provide information that helps combat tax evasion, have led to enthusiastic endorsement of BDTs by some Latin American tax administration officials (Brazil, Secretariat of Federal Revenue 2000). Another point in favour of BDTs is their potentially redistributive character. Coelho *et al.* (2001) argue that the poorest in society are likely to be little affected since they typically are not heavy users of the banking system. They warn, however, that this conclusion would need to be modified if BDTs result in higher prices for basic goods purchased in transactions-intensive retailing outlets.

Preliminary analyses of the implementation of BDTs in Latin America have revealed their administrative effectiveness in raising revenue over the short term. They have been particularly effective in raising revenue in Brazil, Colombia and Ecuador – around 1 per cent of GDP. The strong revenue performance of the Brazilian BDT has been explained by the modest rate at which it is levied, Brazil's significant degree of financial sophistication, and the relative absence of a tradition of moving financial assets offshore (Coelho *et al.* 2001). The fact that the Brazilian BDT was implemented in a moment of extreme crisis when the banking system was fragile may have also played a role.

Despite the positive properties described above, tax policy experts have remained suspicious about the efficiency and long-run macroeconomic effects of taxing banking account debits. That is, perhaps, the main reason why BDTs have been adopted as temporary, emergency measures. They are believed to be inefficient for a number of reasons: the cumulative and cascading nature of their base; and their potential to cause disarticulation in the banking system,<sup>47</sup> reduce market liquidity, and generate economic distortions<sup>48</sup> (Tanzi 2000; Coelho *et al.* 2001). In addition, some of the revenue benefit of BDTs may be offset if they result in increased interest payments on government debt (Albuquerque 2002).

Additional work is required to evaluate the appropriateness of BDT in Latin America. There is to date no study of their impact on income distribution.

### **5.1.5 Taxation of short-term capital inflows**

Between June 1991 to September 1998, the Central Bank of Chile implemented a series of controls on the short-term movement of financial capital. These took the form of an unremunerated reserve requirement (URR). The URR was an obligation to hold, at the central bank and for approximately a year, an

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<sup>46</sup> 'In all cases, with the exception of Brazil, the bank debit tax was introduced at a time of, and in response to, general economic crisis, as an emergency means of raising government revenue' (Coelho *et al.* 2001: 9).

<sup>47</sup> BDTs may create incentives to conduct economic transactions outside the banking system with obvious implications for weakening the development of financial markets and enlarging the informal economy. Statistical evidence of financial disarticulation for the case of Brazil is provided in Albuquerque (2002).

<sup>48</sup> Because BDTs have a cascading or turnover effect, firms have an incentive to integrate vertically, generating less specialisation and also perhaps creating a bias against small firms. Albuquerque (2002) evaluates the macroeconomic impacts of BDTs. He finds that they have a positive impact on real interest rates and a negative impact on the long-run stock of capital.

unremunerated reserve proportionate to the total amount of capital inflows. It was thus equivalent to a tax that declined over time with the permanence or maturity of the capital inflow. Instead of depositing the unremunerated reserve fraction with the Central Bank, foreign investors were allowed to pay the Central Bank an up-front fee, which made the tax nature of this device even more explicit. The fee level was determined by the relevant foreign interest rate and the fraction of capital subject to the restriction. This tax on short-term capital inflows was implemented to improve the capacity of the government to balance its external and internal accounts in an environment of limited exchange-rate flexibility. The tax would offset the appreciation of currency required for a sustainable current account while keeping the interest rate differential in line with a sustainable government budget (Nadal-De Simone and Sorsa 1999).

Several recent papers have attempted to evaluate the effectiveness of Chile's capital controls.<sup>49</sup> There is evidence that URR (a) led to higher domestic interest rates – or at least a larger differential between local and international interest rates; (b) altered the composition of capital inflows in favour of medium or long-term capital inflows; (c) reduced the overall volume of transborder capital flows in ways that eased macroeconomic management (Gallego *et al.* 2002); and (d) provided an incentive for tax avoidance and evasion (Le Fort and Sanhueza 1997). Overall, the impacts on interest rates and on the volatility of capital inflows seem to have reduced vulnerability to economic crisis and created incentives for longer-term investment. However, the benefits of such controls may be temporary and can only be realised if the government or central bank is very active in combating avoidance and evasion. Moreover, it is important to keep in mind that the relative success of Chile's URR may have been due, to a large extent, to the strong enforcement capacity of its central bank, to a long tradition of compliance with the law, and to low levels of corruption. 'Chilean-type capital controls could be less effective and in the extreme could lead to more corruption in countries with a weaker institutional and legal environment,' (Gallego *et al.* 2002: 38).

### **5.1.6 Environmental taxation**

An innovation that appears to be gaining wider acceptability is the use of tax instruments to modify behaviour with respect to the environment. In the case of externalities such as environmental degradation, tax instruments can shape incentives to individuals to achieve desired outcomes. The theoretical basis for this approach is a classical Pigouvian approach to externalities, in which taxes are levied on units of emissions or damage generated by an activity, forcing economic actors to internalise the full social costs of their decisions. Other instruments can also be used to shape behaviour: subsidies, fees, deposit-refund schemes, tradable permits, regulations, and fines. Among these instruments, taxes originally gained popularity because they were believed to provide a double dividend. They offered revenue and more effective protection of the environment. By contrast, regulatory and punishment regimes require bureaucratic oversight and enforcement (Huber *et al.* 1998).

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<sup>49</sup> See Gallego *et al.* (2002) for a recent survey of the literature.

In fact, environmental taxation has also required significant amounts of administrative sophistication in setting rates to match the cost of environmental damage, monitoring and measuring impacts, and enforcing compliance. Instead, other options that are easier to administer have been tried: e.g. taxes on inputs or final goods that are functionally linked to environmental degradation, including petroleum, natural resource exploitation, use or pollution of the environment, and waste disposal.<sup>50</sup> Honduras has experimented with an extremely lucrative petroleum tax as well as taxes on inputs derived from forest products. Other attempts to address environmental degradation have not been entirely consistent with revenue priorities. Tax relief or credit subsidy schemes have proven relatively effective in modifying economic behaviour, but they do not generate revenues, and they demand considerable administrative capacity. Local and state governments in Brazil have experimented with “green” property taxes that offer incentives to land set aside for environmental protection.

An issue raised by environmental taxation, relevant to other types of taxation as well, is the relationship between the revenues raised and the expenditures made. In some instances, local government units administer environmental taxes and target spending on environmental protection. More research is required, but it may be the case that linking the tax base to the expenditure target is an especially effective mechanism to overcome a number of challenges facing taxation capacity more generally. Such an arrangement violates principles of unitary budgeting – as opposed to a budget that is partially subdivided into earmarked expenditures. Nevertheless, such practices may generate coalitions of beneficiaries who will support taxes politically as well as contribute resources to develop institutional capacity.

Especially in locally-administered environmental taxation, macroeconomic and equity issues require attention. In the context of liberalisation and deregulation, environmental taxation will have to reconcile pressures to attract foreign investment and generate revenues. In terms of distribution, environmental taxes will have to be examined closely to determine incidence, as producers with market power probably pass costs to consumers rather than changing their own behaviour. Also, revenues from environmental taxes, especially those administered at the local level, may be difficult to redistribute from rich regions to poor or environmentally degraded regions.

## **5.2 Institutional reforms**

In addition to these rather technical policy innovations, Latin America has been the site of innovations in political institutions related to taxation. Of course, institutions reflect in part the demands of civil society and the interests of political elites, and are thus difficult to change. Still, it is important to identify and encourage those institutional reforms that will support pro-poor tax reforms.

Latin America is perhaps more commonly known as the site of institutional sickness, rather than institutional innovation. Governments in the region, especially outside of the Caribbean, are generally characterised by presidentialism and some form of proportional representation in elections to the legislature (Shugart and Carey 1992; Linz and Valenzuela 1994). Both characteristics have been associated

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<sup>50</sup> See Nellor (1995) for a more detailed discussion of different kinds of environmental taxation.

with stalemate over reforms and pressures for profligate fiscal behaviour. Presidential government, in which the executive must negotiate with an independently elected legislature over fiscal policy, creates an immediate veto point over major reforms. Indeed, this check on executive discretion is one of the reasons presidentialism originally was adopted. However, at moments where major reforms are necessary, presidential systems in Latin America have often been characterised by stalemate and inaction (Haggard and Kaufman 1992; Coppedge 1994).

Stalemates and conflicts in legislatures are exacerbated by weak political party systems. Recent transitions to democracy, and electoral rules such as proportional representation and multimember districts, have resulted in weak parties and party systems. Parties have been characterised by personalism and clientelism, and party systems have been characterised by fragmentation, polarisation, and volatility. These attributes, combined with presidentialism, exacerbate the problems of stalemate between executive and legislature. In many cases, presidents find the only way to pass legislation is to purchase support from legislative allies in the form of spending programmes or tax incentives. These kinds of transactions occur in all polities, but, where party systems are weak, the purchase must be made repeatedly. The long term fiscal burden tends to be high.

Building support for reform is difficult, and pro-poor reform presents particular challenges. In some ways, this may seem surprising, as the vast majority of Latin Americans are poor, and median voter theory suggests that politicians should make appeals to the poor majority of voters. In fact, politicians have had success with anti-poor platforms, for example by utilising clientelistic links to the poor or simply by excluding poor voters or their representatives from the policy process. In addition, voters have been more concerned with other issues, such as inflation or security, and have not prioritised pro-poor policies, including pro-poor tax reform. At the current historical juncture, however, we may have a unique opportunity to capitalise on local support for income redistribution. Competing policy agendas, such as macroeconomic stabilisation, are now less salient, as most countries have committed to relatively sound fiscal policies. At the current juncture, policymakers can return to the important work of addressing inequality, and political competition may revolve more around these issues. In the context of taxation, this means advancing pro-poor institutions and policy. One particular institutional change – in budget institutions – has attracted wider attention for focusing on the way in which executives build support for changes to taxation and bias outcomes towards pro-poor decisions.

### ***5.2.1 Budgetary institutions***

Recent empirical analysis has explored the role effect of budgetary rules on the fiscal performance of Latin American governments (Alesina *et al.* 1999; Stein *et al.* 1999). Alesina *et al.* (1999) uncovered a relationship between fiscal deficits and decentralized budgeting institutions. Stein *et al.* (1999) found similar results for other measures of fiscal discipline (smaller spending, lower debt). Budgetary institutions can have an independent impact on fiscal performance through the “common-pool” characteristics of public budgeting (Weingast *et al.* 1981). While the common pool of tax revenues pays the costs of public projects, the benefits are perceived by specific groups, sectors, or localities. No constituency feels the full cost of

any individual spending decision, while a coalition of groups can almost always be created to seek the benefits. The resultant bargain creates coalitions that support overspending, but none that will support taxation. Institutional solutions to the common-pool problem have been suggested through mechanisms to consolidate the incentives to balance costs and benefits of programmes, and mechanisms to prevent particularist interests from capturing the budget process by forming a dominant coalition (von Hagen and Harden 1995).

Hierarchy and transparency are the two labels usually associated with these solutions. Hierarchical institutions are those in which a centralised unit is responsible for fiscal balance and forced to internalise the full costs of benefits. Executives and finance ministries are usually identified as the offices that can take both costs and benefits into account. Examples of rules that strengthen the hand of these actors are legal limits on the size of deficits, debt ceilings, line item veto, or fiscal targets defined in the context of a macroeconomic programme, approved prior to the budget. To protect the budget from capture by special interests, institutions of transparency have been suggested. Legislative committees, judicial reviews, and citizen oversight, especially through a strong media, are examples of institutions that strengthen transparency.

The move towards more transparent and hierarchical budgetary institutions was pioneered in Argentina and Peru. In Argentina, changes in the budget process were formalised by the Law of Financial Administration in 1992. Changes included the adoption of quantitative spending limits for different ministries at the beginning of the process and the restrictions on the capacity of Congress to propose expenditure-enhancing amendments. In Peru, reform took place in the early stages of President Fujimori's term. Changes in this case included elevating the status of the Finance Minister over that of spending ministers on budgetary matters, requiring consistency between the budget presented to the legislature and the macroeconomic programme, and limiting the power of the Congress to propose amendments to the budget (Stein *et al.* 1999). Similar measures have been adopted more recently in Brazil through the Law of Fiscal Responsibility (Tavares *et al.* 1999).

### **5.2.2 Participatory budgeting**

Participatory budgeting (PB), surprisingly, may both increase the hierarchical power of the executive and increase transparency in implementation. In terms of hierarchy, the PB creates direct authority for the executive by stamping the budget with direct popular approval. At the same time, that legitimacy is only forthcoming if citizens are truly consulted and able to oversee both budgeting and implementation. Over 140 Brazilian cities and six states have applied participatory budgeting in some form, and the World Bank has become so enamoured of the process that it translated a book on the PB from Portuguese to Spanish to distribute it throughout Latin America. Cities in other countries, including Buenos Aires, Montevideo, Caracas, San Denis, and Cordoba, have also experimented with participatory budgeting institutions.

In generic terms, participatory budgeting is a process in which citizens meet in open, public assemblies to discuss the public budget. The meetings begin long before the legislative budget cycle, and occur as regional and thematic meetings. Participants select investment priorities and elect delegates who

continue to meet throughout the year to negotiate the final budget document. To allocate investments, planning officials use the priorities decided by the community in a formula which includes a progressive element that gives weight to needs (Santos 1998). These plans are incorporated into the budget and then passed through the legislature and implemented during the fiscal year. In the following year, budget delegates receive a list of the investments and services planned and actually provided, allowing participants to evaluate government performance and directly question government officials in public assemblies as they design and vote the next year's budget.

The taxation side of participatory budgeting has been little studied, although fiscal capacity has been acknowledged as central to the success of the idea (Avritzer and Navarro 2003; Abers 2000). Fiscal capacity creates room to satisfy demands for investments and provides an incentive for further participation. In most cases where participatory budgeting has been implemented, the problem is the weak fiscal condition of local jurisdictions. In Brazil, for example, approximately 73 per cent of the 5507 municipalities have fewer than 20,000 inhabitants, and most small municipalities depend almost exclusively on external financial resources (Prud'homme 1998).

The work of the International Budget Project in Latin America has confirmed that we know less about the revenue side than budgeting. CIDE in Mexico has done research, and there are groups looking at budgeting and taxation in Costa Rica, but even in these two comparatively advanced countries, the level of expertise and knowledge is limited. In Guatemala the Peace Accords of 1996 and the associated (but as yet unimplemented) national Fiscal Pact led to some research with FLACSO and local NGOs, but this has apparently made little progress in recent years.

There is increasing acknowledgement that local jurisdictions have significant capacity to mobilise resources (Fjeldstad 2001), though political interests and the mobility of capital make it particularly difficult to raise taxes, especially progressive rates, at the local level (Schneider 2003). Participatory budgeting may, however, enhance local fiscal capacity, increase fiscal progressiveness, and increase taxpayer compliance. Indeed, participatory decision-making may be appropriate for mobilising resources even at higher-level jurisdictions (Farias 2003). There are several potential links between participation and revenue mobilisation. As in early European examples of expanding suffrage and empowering democratic institutions, participatory budgeting in Brazil provided greater legitimacy to government. This legitimacy was used to justify increasing tax rates (Fedozzi 2000). After taxpayers were granted more direct political influence and more information about public expenditures, their evaluations of government probity increased, and non-compliance decreased (Abers 1998). In addition, because of the disproportionate representation of poor citizens in the budget meetings, new taxes included elements of progressivity (Marquetti 2000).

### *5.2.3 Intergovernmental revenue-sharing arrangements*

Local governments are a significant, but oft forgotten, component of the revenue structure. Their importance is not simply limited to the revenues they raise, which are usually insufficient (Fjeldstad 2001). Local government has increased in importance in the context of recent democratisation and

decentralisation in Latin America. Both processes increased citizen pressure for greater spending by local governments. Actors at the centre also increasingly directed their attention to local spending as they sought local political support. Further, the retreat of the central state from many areas as a result of fiscal adjustment created gaps in service that local governments were often expected to fill. Even before such demands intensified, most local jurisdictions could not cover their expenses. Most continue to depend on transfers from the central government.

Revenue sharing has long been an important part of intergovernmental fiscal relations in large countries such as Argentina, Brazil, Colombia, Venezuela, and Mexico. Revenue-sharing arrangements have been designed to correct unequal provision of services across regions, and inequality between the revenues available to a jurisdiction and the expenditures it was expected to meet. These arrangements were often reformed in the late 1980s and early 1990s, partly with the objective of compensating for the low revenue mobilisation of local governments (Fjeldstad 2001). Often, the reforms were designed to expand the bases of the central taxes that were the source of the transfers and increase the portion of the income that was to be transferred downward. Municipalities in Brazil and Colombia and provinces in Argentina were the major beneficiaries of such reforms. Fiscal pressure at the central level led to a partial reversal of some of the reforms and to the creation of alternative taxes at the central level that were not subject to sharing. In Argentina, between 1992 and 1994 the federal government managed to reduce the provincial share of co-participation funds by 15 per cent. In Brazil, the mechanism of revenue-sharing was amended in 1994 to reduce the number of federal taxes shared with states and municipalities, and the central government initiated new taxes that were not shared.

These reforms spurred an important debate about appropriate design. Revenue-sharing has been traditionally regarded in the theoretical literature as an appropriate mechanism to correct vertical and horizontal imbalances (Oates 1972). Legal or constitutional (as in Brazil and Colombia) rules for the division of revenues provide subnational governments a degree of predictability that is important for their budgetary planning (Ter-Minassian 1997). Rules-based revenue-sharing systems have also been advocated for equity reasons. The unconditional and pre-established nature of disbursement, if complemented by progressive formulas, allows for a more equitable distribution of tax resources across jurisdictions and is relatively immune from political pressures from wealthy regions (Bradford and Oates 1971).

Revenue-sharing is not, however, without pitfalls. It drives a wedge between expenditure and revenue sources in subnational jurisdictions, and thereby exacerbates the common-pool nature of central government budgets. As a result, if a large share of subnational spending is financed through revenue-sharing, subnational governments may face the incentive to under-exploit their own tax base and focus on obtaining more revenue from above, possibly using overspending by to force the hand of central government. Econometric analyses of Argentine provinces (Jones *et al.* 2000), Brazilian states (Blanco 1998) and Colombian municipalities (Lozano 1999) provide evidence of this type of behaviour.

Rigid revenue-sharing arrangements, with automatic transfers, can be problematic from a perspective of macro-economic management. Every time central government raises taxes to improve its own fiscal balance, subnational governments receive additional revenue, and might use that to undermine efforts at

fiscal adjustment (Dillinger and Webb 1999; Ter-Minassian 1997). In Brazil, this mechanism induced the central government to shift its tax effort away from more efficient but shared taxes, such as VAT and income taxes toward less efficient non-shared cascading and turnover taxes (Viol 1999).

Revenue-sharing arrangements in Brazil and Mexico have also been criticised for failure to promote fiscal equalisation, because of the low weights assigned to regional per capita income and other development indicators in revenue-sharing formulas (Kraemer 1997). There is also evidence that electoral, partisan and other political factors play an important role in determining the regional distribution of transfers. In Brazil and Argentina the spatial representation pattern in Congress was the most important determinant of the distribution of transfers among states and provinces. Over-represented states or provinces received a larger volume of transfers per capita regardless of their development level (Porto and Sanguinetti 2001). An analogous partisan pattern was observed in Mexico (Kraemer 1997).

In short, at least among the cases studied, reforms in revenue-sharing arrangements to induce greater automaticity have compromised the efficiency and macroeconomic capacity of the tax system. Moreover, the arrangements have not fully met the objectives of vertical or, most importantly, horizontal fiscal equity. To the extent that fiscal equalisation may be an important pre-condition for the effective implementation of decentralised welfare or anti-poverty programmes, a more pro-poor tax reform should take a closer look at the design of revenue sharing systems.

## **6 Some conclusions**

### **6.1 IFI policy and Latin American reforms**

Latin America is a middle income region that includes significant pockets of industrial development and a number of poor countries. Prevalent socioeconomic characteristics include severe inequality, significant poverty, a large informal sector, and a large rural sector of concentrated property ownership. Administratively, many governments are corrupt and inefficient, though isolated agencies periodically show evidence of capacity. Governments have faced persistent fiscal crisis and inability to sustain growth and stability after the debt crisis of the 1980s. Politically, most of the region has presidential systems, although some Caribbean countries inherited parliamentary institutions. Almost all countries are democratic, although political parties remain clientelistic, party systems are fragmented and at times polarised, and civil society is weakly organised aside from a few important social movements. In sum, much of Latin America lacks a social contract constructed around inclusive political institutions and development strategies, and institutionalised in tax and fiscal systems.

The Latin American approach to tax reform in the 1990s has focused on improving administration and macroeconomic capacity, with some attention to microeconomic efficiency. In particular, reforms aimed to produce efficient and effective administrations that could implement simplified and neutral tax structures with enhanced revenue capacity. These emphases targeted distortions in market and macroeconomic performance, administrative incapacity, and failed attempts to use taxation to stimulate

industrialisation and distribution. Attention to equity under current reforms has been limited to horizontal equity, with vertical equity treated only indirectly through improved administration, low inflation, and well-targeted expenditure programmes.

The above agenda has been advanced by international financial institutions (IFIs). Despite broad agreement on policies, IFIs have not coordinated their own activities closely. There have been recent efforts to develop a more cooperative and systematic approach. Still, certain areas of tax policy continue to receive less attention, particularly equity and deeper governance concerns.

Latin American governments contributed in the tax reform debate through the design and implementation of alternative and innovative tax reform projects. Tax policy innovations explored presumptive methods of taxation on income, taxation on financial transactions, and alternative methods of taxing property. They have also been framed to address particular features of the Latin American context, such as its large informal sector, dependence on foreign direct investment, and historical resistance to progressive taxation related to wealth inequality. Institutional innovations include new relationships between executive and legislature to overcome political stalemate and new links to society to generate a more inclusive and legitimate social contract.

## **6.2 Outcomes**

Latin American tax reform during the 1990s resulted in progress in the area of tax administration and some policy reforms. Among the set of tax policy reform proposals advocated by the IFIs, three have been fairly consistently implemented: (a) reducing taxes on foreign trade; (b) lowering marginal rates on upper incomes for both individuals and businesses; and (c) simplifying income tax structures.

However, these reforms have been incomplete in several dimensions. For example, reductions in high marginal rates of income tax rates on large taxable incomes have not been followed by a broadening of the income tax bases. Some of the implementation problems stem from the need to prioritise revenue-raising to comply with fiscal adjustment programmes. In addition, political opposition blocked some reforms, and administrative incapacity made others impossible. The departure from more neutral and efficient taxes has been particularly apparent in the area of turnover and general sales taxes. VAT methods would have raised revenues more efficiently, but other taxes are administratively simpler to implement, raise more revenues, and are protected from vested interests.

One of the main failures of the 1990s reforms has been in the area of distribution. Horizontal equity was largely excluded from consideration during the decade, and the regressive impact of many reforms is beginning to become apparent. Several other areas continued to be largely neglected, including taxation of land, small firms, agricultural products, and services. There has been also only limited emphasis on the use of tax policy to promote environmental protection. In addition, the design of revenue-sharing systems and the assignment of tax bases across different levels of government have only recently started to receive more detailed attention.

### **6.3 The politics of tax reform**

The politics of implementing tax reform are poorly understood and insufficiently taken into account in most reforms. Key interest groups may mobilise and institutional obstacles can present veto points that stall reforms. In addition, administrative incapacity may make some reforms unrealistic, even if they are otherwise sound. One result has been the reversal, partial dilution, and outright rejection of certain reforms. On the other hand, some innovative reforms have altered institutions to find a way around institutional or political obstacles, though the longer-term impacts are poorly understood.

In addition, tax reform can have an independent, if unpredictable, impact on political development more broadly. Taxes shape the organisation and mobilisation of groups within society, and embody a social contract between state and society. Certain reforms have flourished by reinforcing this social contract and creating mechanisms of accountability that increase transparency in the use of resources. Nevertheless, an evaluation of reforms in terms of their political incidence is still lacking.

### **6.4 Tax and the social contract**

In most parts of the world, and especially in Latin America, the tax relationship has the potential to firmly embed stable, civic and effective systems of democratic rule that effectively include the poor and disadvantaged. Although quite diverse, most of Latin America has long been characterised by an interlocking syndrome of (a) high economic, social and political inequality; (b) radical disagreement on political institutions and constitutions; and (c) the consequent difficulty of obtaining wide societal consensus over policies to deal with economic problems and crises, such that (d) economic problems can quickly deteriorate into deep, combined political and economic crises. While many factors can help break these vicious circles – and there has been much progress recently in many countries – taxation and tax policy are likely to lie close to the heart of the resolution process. Much of Latin America lacks an (implicit) social contract between governments and the general population of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world.

Fiscal and taxation issues tend to enter into public and electoral agendas in a muted and veiled fashion. Generally speaking, those who benefit in a relative sense from current arrangements – the under-taxed rich – are successful in sidelining debate over distributional issues, and in preventing progressive reform in relation to taxation. Yet many of those same people are likely to benefit – and may be persuaded to perceive that they will benefit – from taxation systems that are more transparent and equitable, provide governments with more resources to address poverty, and command wider public understanding and legitimacy. The challenge is to stimulate and support those debates in a constructive fashion. Fortunately, the goal seems within reach. There are positive features to the current situation in Latin America. They include in particular:

- The widespread recognition in government circles that taxation issues need to be addressed, and the fact that a great deal of reform is underway both in tax administration and in the re-shaping of the tax system.

- The fact that there is capacity and willingness in the region to experiment – often successfully – with a range of new taxes or tax practices that may be better adapted to the needs and circumstances of the region than some of the more formulaic approaches of the international financial institutions.

## **6.5 Challenges**

The challenges facing Latin American tax systems in the next few years are to:

1. Increase direct taxation, especially income taxes.
2. Improve the administration of the VAT, broadening its base by including agricultural goods and services.
3. Re-evaluate the assignment of tax bases and tax revenues among government levels in order to increase revenue mobilisation and tax effort at the local level, minimise interjurisdictional tax competition, and improve horizontal equity.
4. Re-examine the distributive effects of the tax system.
5. Rely more heavily on tax policy to address informal activities and environmental damage.
6. Adjust tax policy and administration to the economic integration progress in order to promote economic competitiveness without compromising efficiency, equity and revenue-raising potential.
7. Tie tax policy to citizen benefits, especially pro-poor expenditures and representation.
8. Improve political institutions in ways that broaden and deepen social contracts. For example, create more responsive and less clientelistic political parties, more cohesive and less polarised party systems, and improved capacity of civil society to monitor government and participate in tax debates.

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