

MANUAL DE CURSO

Taxation and Re-distribution in Latin America

Constantin Groll

The DAAD logo consists of the letters 'DAAD' in a large, bold, blue, sans-serif font.

With financial support from the



Federal Ministry
for Economic Cooperation
and Development

trAndeS *Material Docente Series*

Published by:

trAndeS – Postgraduate Program on Sustainable Development and Social Inequalities in the Andean Region

Lateinamerika-Institut, Freie Universität Berlin, Rüdeshheimer Str. 54-56, 14197 Berlin, Germany

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Editing and Production: Juan Pablo Jiménez / Janina Knobbe / Hannah Pöhlmann / Paul Talcott / Frauke Berg

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Groll, Constantin 2017: “Taxation and Re-distribution in Latin America”, **trAndeS** *Material Docente*, No. 5, Berlin: **trAndeS** – Postgraduate Program on Sustainable Development and Social Inequalities in the Andean Region. DOI: 10.17169/refubium-2528.

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trAndeS Course Reader

Taxation and Re-distribution in Latin America

Aim and Scope of the course

Latin American countries face severe challenges to sustainable development: high levels of social, political or socio-ecologic inequalities, (labor) informality, exclusion and poverty are just the most visible social challenges which ought to be overcome. Most scholars agree that solutions to these challenges won't be implemented by market forces alone. State action has to promote policies which tackle these issues. In fact, most sustainable development goals named in the UN Agenda 2030 call for increased state action and public spending. However, to afford such public spending, states have to strengthen their fiscal capacity, i.e. their ability to collect revenue via tax or non-tax mechanisms. This makes taxation and public finance in general a vital part of sustainable development.

However, even after several years of economic bonanza during the commodity boom, the fiscal and tax situation in Latin America remains complex and perplexing. Although progress had been made in the last decades, most countries still collect too little revenue compared to their level of development, and the revenue they do collect is biased. Tax systems remain being regressive, making no contribution to income re-distribution, and revenues from non-renewable resources still are a dominant source of state income, enforcing economic and fiscal dependence on commodity exports. In addition, tax non-compliance remains high and tax exemptions are frequent suggesting a low interest of high income citizens or large corporations in contributing significantly to the public good. In sum, in many Latin American countries, taxation remains one of the principal obstacles to effective public engagement for sustainable development.

But why does the Latin American tax situation remain suboptimal for sustainable development? This course offers materials, arguments and theories that can provide answers to this question. It also provides students with an encompassing introduction into the research on taxation from an interdisciplinary social science perspective. The course introduces the various facets of taxation and offers an overview of contemporary and classic scholarship on the topic within various disciplines such as economics, sociology, history, political science and philosophy. The aim of this wide perspective is to offer students – unfamiliar with economics – on the one hand an introduction to separate fundamental topics of taxation and at the same time to provide an encompassing view of how taxation can be studied and what kind of different perspectives on taxation exist, why they matter for Latin American societies and how they can improve our understanding of contemporary social, political and economic realities in the continent.

On this builds the normative agenda of this course: reclaiming the pivotal role of taxation for social, human, political and economic development and change. This claim is twofold:

taxation may be used to observe and understand such change, for example in the form of an increase in state capacity because of increased taxation. Following the legacy of Joseph Schumpeter, taxation, however, may also be the very cause of such social changes. In other words, taxation is not only an instrument in public policy, it constitutes a strategic nexus between the state and society and can therefore enlighten our understanding of the social changes and dynamics resulting out of this interaction.

This is also the reason why this course is introductory in nature as it combines, on the one hand, units which treat different topics highly relevant when speaking about Latin American taxation and sustainable development, like re-distribution, tax non-compliance and evasion, or the role and significance of revenues from non-renewable resources. On the other hand, the course also dedicates entire units to single perspectives on taxation, namely fiscal sociology, political science and (economic) history. This allows students to grasp the full potential the study of taxation may have for a deeper understanding of contemporary challenges in Latin America.

Learning objectives

- 1) Students will understand and reflect critically on the core concepts and theories of public finance and taxation.
- 2) Students will understand and will be comfortable to work with data on public finance. They will be able to understand and interpret principal indicators in the public finance literature and taxation and understand concepts and techniques to measure, impute, or theorize economic, social and political effects of taxation.
- 3) Students will have a comprehensive understanding of the characteristics and challenges of public finances in Latin America and are able to put these characteristics into a comparable perspective. Given the theories and arguments they have studied during the course they will be able to explain why these challenges persist and assess the prospects of Latin American taxation given certain economic, social or political changes.
- 4) Students will gain a comprehensive understanding of what can be “measured” with taxation, tax data or behavior and how these “measures” relate to historic, social, economic or political phenomena found in the region and what this means for sustainable development.
- 5) Students will have an idea about several macro approaches to public finances in different disciplines (economics, political science, sociology, history and philosophy), are aware of the principal debates in these disciplines and are able to apply these perspectives to study and explain selected topics of public finances and taxation in Latin America.
- 6) Students will be able to present tax data and make presentations on key topics of taxation in the Andean countries based on their experience in the group work.

Organization of the course

The course is organized in twelve units. Units one to five offer a disciplinary introduction to taxation and present the dominant debates, theories and perspectives on taxation in public finance and economics (Unit 1), history (Unit 2), political science (Unit 3), sociology (Unit 4) and philosophy (Unit 5). These units have a more general scope. They encompass discussions that go beyond the Latin American tax reality and take advantage of research in other areas of the world. However, the interest is more theoretical in nature, establishing the foundations for a multi-dimensional understanding of taxation. Unit six to eleven offer an introduction to one critical aspect of contemporary Latin American taxation. These units treat topics as diverse as tax policy reform (Unit 6), taxation and re-distribution (Unit 7), the transnational dimension of taxation (Unit 8), tax non-compliance (Unit 9), the taxation of non-renewable resources (Unit 10) or the challenges in local and regional taxation in Latin America (Unit 11). All of these topics entail major challenges for fairer and sustainable public finances in the region. But instead of providing uniform answers, the idea of these units is threefold: They aim to show the empirical tax realities in Latin America, teach the progress of existing research on these topics and the forms of how these topics are studied, and provide solutions which are deduced from this research that are relevant to the contemporary tax challenges. Instead of a course summary, Unit 12 proposes an exercise of knowledge transfer. Students can apply the knowledge they have learnt during the course thinking about the relationship between taxation and sustainability in the Andean context. They may choose some empirical example and theorize about the relationship between different aspects of sustainability (fiscal, social, etc.) and taxation, building on the group work of the previous units.

In this course reader, each unit is presented in a short and general description outlining the main topics and ideas which can be discussed and the learning goals which can be pursued during the session. As it can be seen these are often very encompassing topics and presentations. This is why lectures may pick only some of the topics mentioned in the description or even opt to teach one unit during several sessions. Lecturers can also opt to teach one unit in two sessions, where the first session introduces the general theory of the topic and the second session is filled with the group exercise, i.e. the application of the topic to the Andean context. In addition, to the unit description the reader offers a list of publications which aim to represent the most relevant literature on the topic without any claim neither to completeness nor exclusiveness. It offers students as well as lecturers an overview of the topic's literature, including classic as well as contemporary contributions.

Finally, the course reader proposes – if feasible – exercises which students can solve and work in groups. These group exercises are optional and may be combined with standard tasks for students at an individual (individual presentations) or collective (text discussion) level. The aim of such group work is to provide space where students can apply their skills or knowledge to a specific topic and may share their results with the class. The proposed group exercises are also a valuable option to introduce the tax empirics of the Andean countries into the course.

Proposed student evaluation

Reading load: approx. 35-40 pages / unit

15% Participation in class

15% Group work I and in class presentation

15% Group work II and in class presentation

15% Group work III and in class presentation

40% End term essay (5000 words)

Unit 1: Public Finance Theory: Functions, Concepts and Effects of Taxation

Before getting started it is important to understand some key concepts of taxation. This helps to lay out the proper definitions used in the realm of public finances and avoids misunderstandings. First, this section discusses what taxes are, what kinds of taxes exist and how they can be best described. As taxes are unthinkable without government, a short overview of how the classic public finance literature portrays government is presented. This enables us to understand how public finance scholars view taxation and what kind of role they reserve for it in their reasoning. The section goes on to describe the five principles of taxation highlighted in public finance textbooks (Stiglitz 2000, Gruber 2012, Rosen and Gayer 2007) and finally, as economists are principally concerned with the effects of government interference (here in the form of taxation) on the forces of the free market, the (economic) effects of taxation named in this literature are summarized.

Learning goals:

1. Students are familiar with basic definition of the functions and concepts of public finance and taxation.
2. Students know the principles that tax systems should fulfill and have considered them critically.
3. Students understand the effects of taxes in the economic process, i.e. their effects on individual behavior, income and prices discussed in the economics literature.

1.1 Key concepts of taxation

Classic contributions ascribe three functions governments should pursue via fiscal policy (Musgrave 1972): secure (market) efficiency, maintain macroeconomic stability and enhance equity (via re-distribution). The first function refers to setting and enforcing the rules of market interactions and in doubt correcting market failures. This includes efforts to contain the powers of monopolies, secure the provision of public goods (research, defense, etc.) and limit negative externalities (for example air pollution). Secure macroeconomic stability - the second function - includes fiscal policy measures to maintain price stability and avoid high inflation or moderate business cycles (boom and bust). Finally, the third function is to engage in re-distribution to enable fair access to markets and secure social stability. We can think of forms of taxes or public spending which aim to contribute to one or all of these goals. However, to what extent these goals should be pursued, e.g. if the very rich should be taxed in order to reach the redistribution of income, is controversial. So, taxation and public spending can be seen as a major regulatory policy which affects all of these three functions as well as it can be used to pursue them. In the following section, we focus on taxes as one of the policies in public finances and discuss their use.

What are taxes and how are they measured? In reality there are all kinds of mechanisms the states collect money from its citizens, for example via taxes, fees, contributions, duties or other fiscal payments, and one can easily get lost in the diverse concepts of domestic public

revenue system. However, there are some guiding principles that help to distinguish taxes against other revenue mechanisms (although frequently even some states do not apply them properly and frame non-tax revenues as taxes).

Taxes can be defined as cash transfers, which are paid without being compensated with a specific service. Taxes are paid to a public-law entity with the aim to increase its revenue and the definition of who has to pay taxes is stated in the law. Thus, the main features of a tax is that it is (a) compulsory, it is (b) a contribution paid in money, there is (c) no return in services and that they are (d) levied by public entities and typically they are levied by reason of law. Maybe the most important difference between taxes vs. fees, contributions or duties is the kind of service which individuals receive for their payment. One can say that the more the service has a public good character, the better the contribution is designed as a general payment, i.e. a tax. The higher the service has a private good character; the better the payment is designed as a fee or contribution.¹

This is a general definition of taxes but as we know there are several kinds of taxes. Generally, taxes can be differentiated by answering four simple questions: What is taxed? This describes the tax base. How is it taxed? This describes the form of the tax rate, the technique how the tax is levied, e.g. annually or permanently. Why is there a tax? This describes the aim of the tax. Who will receive the tax? Here is meant which level of government benefits from the payment, e.g. municipal, provincial or federal government.

If we take all kinds of taxes (and often non-tax revenues) into account, we can speak of the tax system or tax regime. Here, along with the level of taxation, which is commonly measured in % of GDP (the total amount of revenues that are collected via taxation as share of GDP), another important aspect is the ratio between direct and indirect taxes. Direct taxes are levied directly to the economic subject (e.g. an income tax); indirect taxes are levied upon costs, receipts or transactions (e.g. a value-added tax or sales tax). As direct taxes, especially taxes on income and property are said to have the potential for a great redistributive impact, i.e. individuals with higher incomes may be required to pay a higher share of their income to the state in the form of tax (see also ability to pay principle, see Unit 5), this ratio is also a first frequently used approximation of the progressiveness of a tax system. Distribution and progressiveness will be treated in Unit 5 and 7 when taxation and inequality is discussed.

Next to the ratio between indirect and direct taxes, tax rates are also of importance to characterize single taxes and the tax system. Of great importance in discussing tax systems are: the **statutory tax rate**, which describes the legally imposed rate – for example, an income tax can have multiple statutory rates for different income levels, where a sales tax may have a flat statutory rate; the **average (effective) tax rate**, which is the ratio of the total amount of taxes paid to the total tax base (taxable income or spending), expressed as a percentage. The effective tax rate: the average rate at which an individual is taxed on earned income (effective tax rate of the income tax) or the average rate at which a corporation is

¹ Note here that the difference between private and public goods is determined by the two key concepts of non-rivalry and non-excludability in consumption.

taxed on pre-tax profits (effective tax rate of the corporate income tax). Note that these rates may differ from the statutory tax rate due to tax incentives, exemptions or tax credits (see Unit 9). The marginal tax rate, which is the tax rate individuals would pay on one additional dollar of income.

1.2 Principles of taxation

Classic economic literature highlights five core principles tax systems should comply (Stiglitz 2000: 457). Obviously, these principles have their background in economic theory. However, as most contemporary discussions about taxes draw on one or more of them it is worth becoming familiar with them. Textbook advice is that tax systems design should aim to fulfill economic efficiency, administrative simplicity, flexibility, political responsibility, and fairness. In the following, all three of these principles are briefly described. It is recommendable to discuss them critically in class, e.g. based on the literature provided in the annex.

- (a) **Economic efficiency.** Under this principle, the tax system should not interfere with the efficient allocation of resources. Economists are especially concerned with the market distorting effects of taxes. They argue that in absence of market failure, the economy would automatically allocate resources efficiently. Information conveyed by market prices would lead to production, exchange, and product mix efficiency. No one could be made better off without making anyone worse off (in other words a pareto-optimal equilibrium). Taxes may affect this (theoretical) condition as they may alter (relative) prices and thus distort the allocation of resources (price effects) or they may alter the behavior of economic actors (behavioral effects) or affect the general economic equilibrium, as described above.

- (b) **Administrative simplicity.** This principle insists that the tax system ought to be easy and relatively inexpensive to administer. Administering a tax system entails significant costs. Such costs can be divided into direct, e.g. the cost of functioning of the national tax authority and indirect costs. Indirect costs are borne by the tax payer and may include various items such as time of processing the tax forms, cost of record keeping, etc. Generally, and especially in Latin America, indirect costs are far greater than direct costs.

The costs of administration have been a major issue in tax reforms in Latin America, however, as they depend on various factors, some of which are exogenous to the administration, they are not easy to reduce. Administrative costs depend on the requirements tax payers have to meet (record keeping, reporting, etc.) to pay the tax. The second factor which determines the administrative costs is the complexity of the tax systems. In Latin America, especially during the 1970s and early 1980s, tax systems were very complex with lots of different taxes and multiple exemptions. Since then the complexity of tax systems has certainly been reduced but tax exemptions and other forms of tax incentives are still an issue in many Latin American countries, which raises the costs of administration (see Unit 9). Thirdly, administrative costs depend on what is

being taxed. Generally, it is said that such costs are higher for imposing taxes on capital than imposing taxes on income, because of the difficulties for tax authorities to distinguish between (capital) income and capital. Finally, the administrative costs also depend on the structure of the economy, for example the concentration of capital or the existence of a large informal sector (a pressing challenge in many Latin American countries).

- (c) **Flexibility.** Textbook advice maintains that the tax system ought to be able to respond easily (in some cases automatically) to changed economic circumstances. Changes in economic circumstances require changes in tax rates. Some tax structures adjust easily and automatically, but other adjustment depends on policy action. In the economic literature, there great importance is given to the existence of automatic stabilizers within the tax system to smooth economic cycles. For instance, if prices are stable (or tax brackets adjusted to inflation) a progressive tax structure can provide an “automatic” stabilization to the economy. When income drops during a recession the average tax rate is reduced and individuals face lower tax rates as their income is lower. Individuals will have more relatively money to spend and help to increase or stabilize demand. On the contrary, when income increases the average tax rate increases and can contribute to smooth revenue flows during economic boom periods.²

The goal of a flexible tax system includes also being able to adjust the tax system to changing circumstances quickly. However, as some adjustment involves an intensive political debate – which taxes to cut for whom during a recession – perfect timing may be difficult. During high economic volatility, the lag between decided changes, their enactment and the collection of the tax can have a negative impact on the efficiency of the measures taken. In Latin America, in a general perspective, tax reforms over the past 50 years have been frequently undertaken as ad-hoc reactions to economic or fiscal crisis and boom times, highlighting the lack of government willingness to engage in long term tax planning and the importance of politics in taxation. This is why in Unit 6 tax policy is treated separately.

- (d) **Political responsibility.** Connected what will be discussed in Unit 3 and 4 in more detail, economic textbooks advise that tax system should be designed so that individuals can ascertain what they are paying, and evaluate how accurately the system reflects their preferences. First this means that tax systems should be designed in a way that they are transparent and understandable to tax payers. Tax system transparency is said to have a positive effect towards tax compliance and acceptance (see Unit 9). Moreover, transparency also empowers citizens to know how much they contribute to the state and compare their “sacrifice” with the benefits they receive and thus better enabled to hold the government accountable. Yet this is not always the case. Particularly in Latin America political responsibility of tax systems is not always met. This topic is linked to

² However, during times of stagflation – times of economic expansion and inflation – tax brackets adjusted to inflation lose the built-in stabilizing effect of a progressive income tax. However, the effect works if prices rise during recession.

discussions in Unit 3 & 4, which include perspectives of tax systems as fiscal contract between citizens and the state.

- (e) **Fairness.** Finally, textbooks advise that tax systems ought to be fair in its relative treatment of different individuals. In terms of economists, tax fairness is frequently measured by two principal goals: horizontal equity and vertical equity. Note here that economists use the term of *equity* rather than speaking of equality, which is the focus in philosophy, law and sociology. *Vertical equity* means the principle that groups with more resources should pay higher taxes than groups with fewer resources. There are different reasons to back up this claim (see especially Unit 5). Economists however justify this principle by referring to the idea of a utilitarian welfare function (see also Gruber 2012: 533). This approach claims that lower income groups gain higher utility from income than higher income groups as the marginal return on income (in the form of utility) decreases with increasing income (especially once the basic needs are covered).

For economists, three problems arise if vertical equity of tax systems ought to be assured: defining who is in the position to pay more than other, i.e. on what grounds this decision is made (1), the problem of implementation (2), how much more should someone pay if he gains more (3). Different answers to these questions exist and some of them are discussed in the texts. One critical question is defining the “ability to pay” of tax payers. Here different measures are discussed concerning how this ability can be measured: a) income as a basis of taxation; b) consumption as a basis of taxation; c) lifetime income as the basis of taxation; d) cost-benefit principle as the basis of taxation; e) alternative approaches; f) critics of income as basis of taxation.

Also critical is to find a measure which describes the vertical equity existent in a tax system. In the economic literature, three measures are frequently used to determine if the principle of vertical equity is met. They are also the subjects of the most commonly mentioned tax reform debates: Progressive tax systems, regressive tax system and proportional tax systems. Progressive tax systems describe tax systems in which the effective average tax rate rises with income. In regressive tax systems, by contrast, the effective average tax rate falls with rising income. In proportional tax systems, effective average tax rates do not change with income, thus all taxpayers pay the same proportion of their income in taxes.

Horizontal equity refers to the principle that individuals who are the same in all relevant aspects but make different economic choices are treated similarly by the tax systems. This principle appears to be easy to understand and implement. However, it has some implications which cannot be solved by economic reasoning alone. For example, the principle does not specify which aspects, or (better) categories to distinguish individuals should be defined as relevant. Easily one might agree that categories such as race, color, age or even marital status (married, unmarried) should be counted as relevant aspects. However, most tax systems in the world make a distinction of tax payers in terms of age and marital status (see literature on the gender bias in taxation in Unit 4). In fact, it might

be easier to determine which aspects of comparing two individuals are not relevant. Take the example provided by Stiglitz (2000: 467-8) of two identical twins buying chocolate and vanilla ice-cream respectively. This ice cream is taxed with different rates. “Is the tax system treating the two individuals in a horizontally equitable manner if it taxes vanilla and chocolate ice cream at different rates?” (2000: 467). At first sight taxing ice cream at different rates appears to be unfair. However, the difference in tax payments of the twins is not based on a relevant aspect of their personality, but on difference in taste. In fact, both individuals face the same “opportunity set” (for both it would have been possible to buy vanilla if they have wanted to). Thus, in this case the tax system did not discriminate, as it did not differentiate between the two individuals. This example can also be applied to “commodities” or other goods. Frequently governments tax goods differently, e.g. beverages with different degrees of alcohol. What becomes apparent here is that tax system design implies moral choices and reflects decisions about aspects which transcend the realm of pure economic thought or better quantitative thinking (see Unit 5).

1.3. Economic and individual effects of taxation

As mentioned in the economic literature, the effects of taxes are of special importance. The main idea is that taxes interfere in the pareto-optimal allocation of capital and labor. In order to gain a better understanding of the effects described in public finance textbooks the unit proposes a group work exercise (see box above). This is why in this text the effects are only mentioned briefly and a more thoughtfully discussion is reserved for the class exercise:

- (a) **Behavioral effects.** The basic idea is that any tax has an influence on the behavior of economic actors. Actors respond in some way or the other to the reduction of individual revenue which is caused by their tax payments. Economists speak of non-distortionary taxes, “if, and only if, there is nothing an individual or firm can do to alter his tax liability” (Stiglitz 2000: 462). Non-distortionary taxes are also called lump-sum taxes in the literature.³ One of the main distortions is caused by the attempt of economic actors to reduce their tax liability. i.e. the tax may induce a change of the (economic) behavior of the taxpayer. Most taxes however are distortionary. For instance, in the case of a tax on commodities (including services, etc.) a consumer of these commodities can reduce or shift his consumption. Taxes on income (salary) are distortionary because workers may opt to work less and thus reduce their tax liability. The distorting effects of taxes take up considerable room in economic tax theory, because under certain conditions more revenue could be raised with the same effect on individual welfare changing from distorting to non-distorting taxes. This is for example the case in discussions of optimal tax theory (see literature). Behavioral effects also include instances when customers, workers or producers aim to reduce their tax liabilities via other behavioral changes; for example, withholding or rejecting investment or changing the own saving behavior.

³ For example, a tax which is based on unalterable characteristics of persons (male/female) or a “head tax” that everyone has to pay independent of their income or wealth is a lump sum tax.

- (b) **Income and substitution effects.** Income effects are best visible in taxes on consumption. For example, if an individual consumes less because of higher relative prices because of a tax. The amount by which his consumption is reduced is called the income effect. In addition, as the relative price of the good for which the tax applies increases, consumers may consume other goods (substitutes). The extent to which consumption of the taxed good is reduced because of the increase in relative price is called the substitution effect.
- (c) **Other effects of taxation** are financial effects, organizational effects, general equilibrium effects, announcement effects and capitalization. There are also other effects on more specific aspects of the economy mentioned in the literature. Without mentioning them in detail in this text, the main aim of public finance economists is to design the tax system in such a way that these effects and their impact are minimized. Thus, one research agenda of these studies is, next to determining the effect of certain taxes, to develop a positive theory of how to best design specific taxes as well as an overall tax system.

Group work exercise:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group reads the description of one effect of taxation provided in Stiglitz (2000) as well as engages in individual research about the effect in question. A possible allocation of topics is one of the following effects to each group: a) substitution effect; b) price effect; c) consumption effect; d) other behavioral effects. In addition, one group can also summarize the principal ideas of optimal tax theory. The groups try to understand the effects and prepare a presentation (short PowerPoint 2-3 slides, or brief summary of max. 1 page) discussing the effect and – if possible - search for an empirical example (in Latin America). One or two members of the group will present the group work to the whole class in the form a five-minute pitch. After the presentation, the effects will be discussed in the whole class and the material elaborated by the groups and class will be shared collectively.

Literature:

Gruber, J. (2012): *Public Finance and Public Policy*, Worth Publishers.

Chapter 18

Chapter 19

Chapter 20

Mankiw, N. G.; Weinzierl, M. and Yagan, D. (2009): “Optimal Taxation in Theory and Practice”, *NBER Working Papers*, No. 15071, National Bureau of Economic Research, at: <http://tinyurl.com/zgt8unv> (Last access 01.10.2016).

Musgrave, R. (1959): *The Theory of Public Finance: A Study in Public Economy*, New York: McGraw-Hill Book.

Rosen, H., Gayer, T. (2007): *Public Finance*, Boston: McGraw Hill Irwin.

Chapter 14

Chapter 15

Chapter 16

Slemrod, J. (1990): “Optimal Taxation and Optimal Tax Systems”, in: *Journal of Economic Perspectives*, 4, 1, 157-178.

Stiglitz, J. (2000): *Economics of the Public Sector*, New York and London: W.W. Norton & Company.

Chapter 17: Introduction to Taxation

Chapter 18: Tax Incidence

Chapter 19: Effects and economic efficiency

Unit 2: Historical Dimension of Tax Systems: Latin America in Comparative Perspective

Similar to other social, legal and political institutions, tax regimes have histories such as the social and political struggles that are shaping them. Understanding these histories offers valuable insights to the contemporary challenges of taxation in the region as well as to the specifics of the tax state in a particular country. This is of special importance as tax regimes in the region still suffer several shortcomings which put in question the sustainable financing of Latin American countries. Such challenges exist e.g. in the low level of tax collection compared to the level of economic development, volatile and disperse tax bases, a very low to zero contribution to income distribution via taxation, moderate to high dependence on revenues from non-renewable resources such as oil and minerals, and high levels of tax evasion and avoidance. All these contemporary features have historical roots and a look into history can help to understand their persistence. In addition, Latin American tax systems differ considerably among countries. Comparing the genesis of different tax systems in the region is an important perspective to account for these differences and determine the factors or events which are relevant to understand the particularities in tax regime design.

The historical dimension of taxation has attracted important scholarly attention in Latin America and beyond. The aim of this unit therefore is twofold. First it provides a short introduction in the development of tax systems in the region, highlighting the particularities of this history in a comparative perspective. Secondly, it introduces several major discussions in the literature such as the colonial heritage of Latin American tax states, the imprint of (developmental) ideas, the relationship between war and the tax state or the particularities of the introduction of the Latin American income tax. Several of these topics are still relevant for contemporary analysis of tax regimes in Latin America and will therefore be treated in related units (see Unit 3, 4, 7).

Learning goals:

- Understand the origin of the tax state and its connection to the rise of the modern nation state.
- Understand the differences between the formation of the tax state in Europe and Latin America and the implications of this difference.
- Be able to recall the different perspectives on taxation in Latin American economic thought, particularly in modernization and structural economic theory.
- Be aware of the long-term development of Latin American tax systems (periodization, critical junctures, differences between countries, etc.).

2.1. Taxation in Latin America in a long run perspective

The evolution of Latin American tax system has been by no means a linear process. To the contrary, we can detect critical junctures – events that marked a decisive inflection point in the tax system development – and macro-periods in which a common paradigm of tax policy

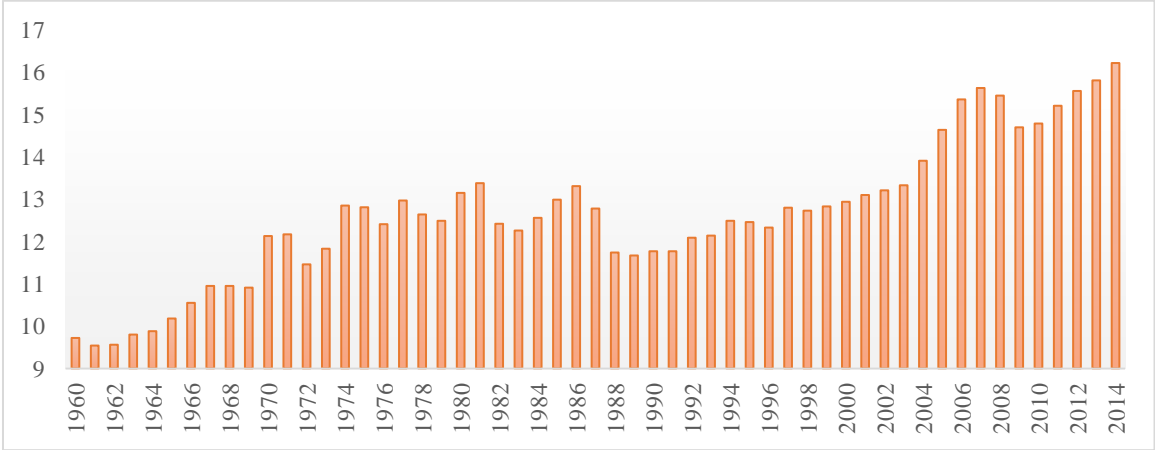
can be observed, as well as characteristics which have been considerably stable over time and which can be related to path dependent processes in Latin American history. The goal of the analysis of the historical dimension of taxation is to encounter all three of these aspects.

Without neglecting the importance of national differences, it is useful to recall the trends in tax collection and the tax mix over the last decades for a first approximation of Latin American tax history. Comparable historical data is not easy to obtain for the whole of Latin American countries, and for the sake of illustration this introduction is limited to the exploration of the last 50 years. Figure 2.1 shows the evolution of Latin American tax revenues based on the data on central government tax collection for 18 Latin American countries compiled by Morán and Pecho (2016) for the period between 1960-2014. In this figure, the rise of central government tax revenues by 6.5 percentage points of GDP during the last five decades, from an initial 9.7 % of GDP in 1960 to 16.2 % in 2014 can be observed. Within this timespan one may distinguish five periods of the tax system's evolution, reflecting distinctive approaches to tax policy, levels of tax collection and tax structure in the subcontinent.

1. From the 1960s to the mid-1970s, the time of the oil crisis: The strong rise in tax collection (by 3.31 percentage points, from 9.54 of GDP in 1960 to 12.85 in 1975) was principally due to the paradigm shift in tax policy. In economic theory, public economics started to put relevance to taxation not only as a revenue collecting mechanism but as an important tool for economic development. The region also was affected especially by the Joint Tax Program, initiated by the Alliance for Progress, which became one of the main actors in tax reform in Latin America. Together with an overall positive macroeconomic environment, this program had a positive impact on increasing overall tax collection in the region. Taking a look at the average tax mix in this period, as seen in Figure 2, one can also appreciate these changes. The relative share of taxes on goods and services increased while the relative weight of taxes on trade, the bedrock of Latin American taxation during the early state building years through much of the first half of the 20th century, decreased. The relative weight of direct income taxes, principally corporate income tax (in this time frequently state-owned) and personal income remained also relatively high.
2. From 1970s onwards to the end of the 1980s: Tax collection did rise at some points but also was highly volatile. This reflects the economic volatility during this period but also changes in policy ideas on taxation. Around 1973 with the oil crisis, certain ideas on taxation changed. The advent of supply side economics, which emphasized the reduction in efficiency losses inherent in taxation, propagated a downsizing of taxes, especially direct taxes. The overall political and economic environment (inflation, fiscal deficits, rising debt, frequent regime changes and the struggle for democracy) also reduced overall tax collection. Instead for many governments in the 1970s contracting foreign debt, which in a more abstract way can be seen as a tax on future earnings, was a handsome solution to their fiscal problems.

3. In the 1980s as debt levels became unsustainable, solutions to the high and unsustainable debt levels frequently induced by the “Washington consensus” organizations included a series of tax reforms with an emphasis on simplification and efficiency.

Figure 2.1: Evolution of average tax revenues as a percentage of GDP of 18 Latin American countries, 1960-2014

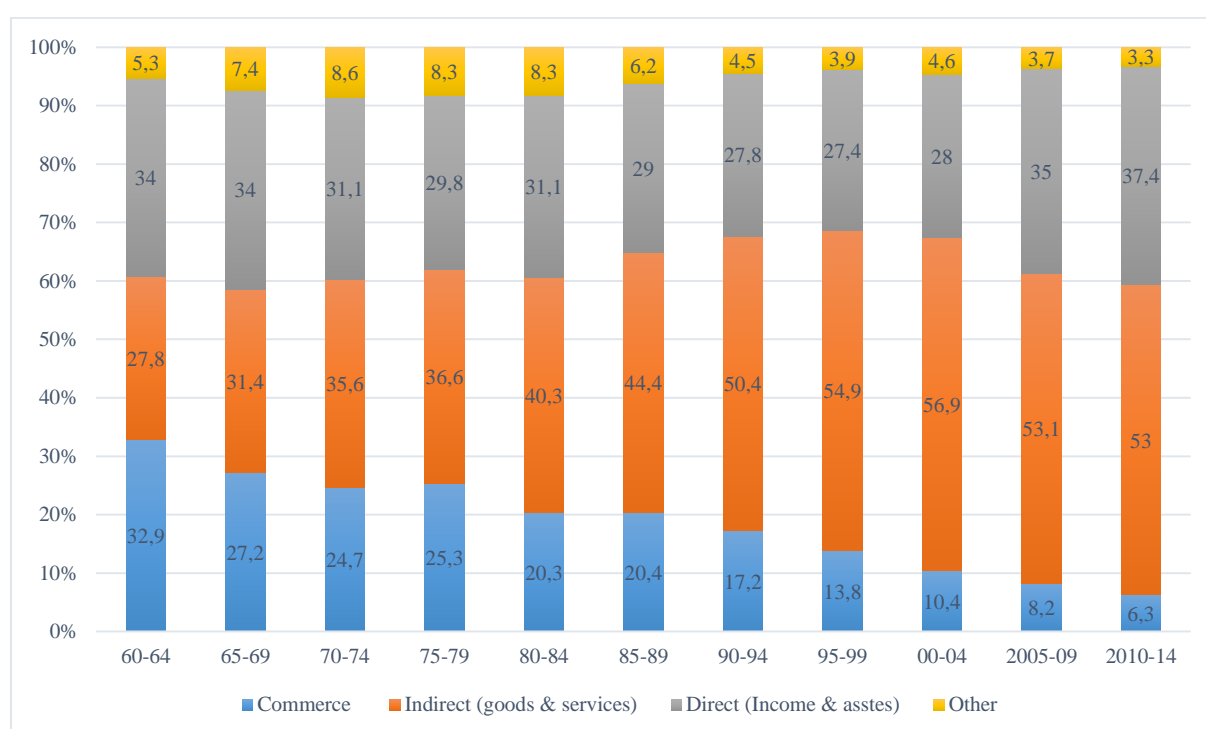


Source: Own elaboration with data from Morán & Pecho 2016, p.2; Central Government revenues.

4. From the 1990s to the year 2001/2: This period is often described as the time of “liberal tax reforms” (although some of these reforms have already been enacted before 1990). Tax policy, in line with principal ideas of the Washington Consensus, set out to eliminate taxes on international trade and replace the lost revenue (at least partially) with a solid tax on goods and services (principally the VAT), decrease rates in income taxes, and broaden tax bases (i.e. delete exemptions). Nevertheless, the emphasis of liberal reforms does not describe all policy changes. Some Latin American countries also introduced new ‘heterodox’ taxes, such as the tax on financial transactions or simplified regimes for small businesses, and the political independence of tax administrations was strengthened and modernized. The principal aim of these reforms was to bolster collection, encourage foreign direct investment – at the cost of distribution and progressivity – in order to decrease the fiscal deficits in the region. However, with frequent global economic shocks (Russia, Mexico, the Asian Financial crisis) and unsophisticated economic growth, increases in tax collection were modest, only by 1.44 percentage points on average and too low to satisfy social demands or stimulate long term growth. The re-shifting of the tax mix from direct and trade taxes to indirect taxes is also visible in figure 2.
5. During the commodity boom period between 2002 and 2013/14: Average tax collection reached new heights and the average tax mix started to be re-balanced. Thanks to an almost unprecedented period of sustained high commodity prices and economic growth, tax collection rose up to 16.2 % of GDP. In policy terms, three trends stand out. Governments engaged in tax reform that modified the taxation of the extractive industries (see Unit 10). Some governments engaged in modifications in the taxation of personal income taxes, though not increasing its relative importance but making personal income

taxation more progressive (see Unit 7). Tax administrations were modernized and strengthened (including an increased interregional cooperation) and, in some countries, new heterodox taxes (such as the export tax in Argentina) were introduced. These were, however, except for some minor cases not structural tax reforms but rather a pragmatic adaption to the economic cycle. In fact, one may argue that the countries benefited in some ways from the reforms of the 1990s which put emphasis on indirect taxation (VAT) which naturally rises with economic growth. The increase in the relative share of direct taxation was especially due to the increase in corporate income tax, thanks to the positive economic cycle (see Figure 2.2).

Figure 2.2: Evolution of Tax Structure of Latin American tax systems, 5- year average as a percentage of total tax revenues, 18 Latin American countries, 1960-2014



Source: Own elaboration with data from Morán & Pecho 2016, p.10; Central Government revenue

2.2 Research on the historical dimension of taxation in Latin America

With this short sketch of Latin American tax history in mind, two questions emerge: How can we explain changes in (tax) institutions over time and why different societies might develop different sets of institutional (tax) arrangements? These two questions lie at the heart of much research that explores the historical dimension of tax institutions in Latin America and beyond. While, as we will see, this research differs in many ways, it shares the conviction that the history of institutional development provides superior explanations as de-contextualized and a-historical models and explanations for tax changes and evolution. In the following some of the main ideas of the most influential perspectives are described briefly:

- *Modernization theory and early development economics*

The question what drives the development of tax institutions has been the key question to early modernization theory and early development experts. Despite differences in their reasoning, their key answer was economic development. Perhaps the most classic form of this idea was already mentioned in the work of Albert Wagner, a member of the nineteenth-century German Historical School of economics. Wagner linked a country's level of economic development to the increase in the relative size of its public sector and, hence by implication, its revenue-generating abilities (Wagner 1890). This idea also known as "Wagner's law" – the natural tendency that the tax state grows with economic expansion - was later re-discovered by modernization theory, however with a certain twist. Economic development would progress within stages (see Rostow 1960) and run from an agrarian society up to a "modern" industrialized society. Taxation would follow this trend, or as Edwin R.A. Seligman claimed "fiscal conditions are always an outcome of economic relations" (1895-1931:1). The heyday of development economics also encompassed the international advisory missions by development economists and tax experts, most prominently for Latin America connected with the mission of Nicholas Kaldor as part of US foreign aid policies during the Cold War. In the view of these experts Latin America needed to "learn to tax", that is make taxation efficient, productive and equitable in order to support the transition of their economies, i.e. support the movement from one stage to another. In the most basic form this meant: there had been low taxation, mostly in-kind (e.g. as a share of harvest) in agrarian societies as little surplus was produced. Later, with the growth of markets and the development of industrial production, tax policy should be expanded to include new kind of taxes of the economic surplus, and as trade expanded, trade taxes could be introduced as well (despite taxes on the products of land).

The second twist in modernization theory was that economic development also was expected to bring democracy (Lipset 1959). As democracy required governments to increase legitimacy, it was expected that governments would react with the introduction of modern taxes, including redistributive taxes, which on the one hand expanded the fiscal space of the state and thus its spending hand, increasing legitimacy through output (in services, infrastructure, etc.) but also expanded compliance via securing equality and thus increasing legitimacy in the lower income strata. Here an idea was expressed which later become of wider importance: the democracy – taxation hypothesis: democracy has a positive effect on taxation, as there is "no taxation without representation" (see Unit 3).

The modernization theory, however, ran not only in the trap that it had a very specific normative and teleological underpinning but also that it lacked a way to account for the differences in tax system trajectories observable in non-industrialized countries. Why did tax systems evolve and remain different if there was supposedly a common path to modernity and by this a convergence of tax systems? The answers were not satisfactory and variation would be for example explained with different "cultures" which led modern societies to choose different policies. This critique highlights the weakness of modernization theory to provide a basic answer to actor choices in taxation, namely why would actors consent to a fiscal contract (paying taxes in exchange for services and rights) and how such a contractual

situation – today often framed as equilibrium - could be maintained. The elite theory approaches, prominent in public choice theory from the 1960s onwards, but also later in a different form of a revaluated neo-institutionalism, provided a better account for these questions. These approaches are discussed in Unit 4. Beside the fallacies of modernization theory, there are still authors who claim that a positive link between economic development and taxation is empirically observable (see Gupta 2007, and Pessino and Fenochietto 2010, among others).

- *Taxation and War – State-building literature*

One of the most prominent explanations of tax state development was already put forward by Joseph Schumpeter, an intellectual founder of the fiscal sociology school (see Unit 4). Schumpeter borrowing from his Marxist contemporary Rudolf Goldscheid posed the question why European societies developed a bureaucratic tax state in the first place. He found the answer in war and military conquest. Taxation and with it the construction of a bureaucratic state apparatus to collect these taxes was needed to finance standing armies. Standing armies financed by taxation were the answer to overcome the hurdles kings had to overcome in the light of military conflict. They provided a suitable alternative to the frequent pledges of support (in personal or finance) to royal allies (dukes, princes, earls, etc.) kings had to engage because their own military capacity was insufficient to confront military threats.

In a seminal study, Charles Tilly (1992) expanded this idea to European state building in general. In their view the war-state nexus was the crucial, critical juncture, for European state building. As revenues were needed for war, rulers engaged in taxation. Taxation however implied the built up of an administrative corps, which was nothing less than the foundation of modern bureaucracies, the core of modern nation state. Wars and belligerent rivalry between European states was thus a critical juncture of both the rise of the modern nation state and taxation. Following Tilly (1985:180) “war, state apparatus, taxation, and borrowing advanced in tight cadence”. A follow up of this idea is that the tax state and especially (modern) direct taxation was the observation that rulers engaged in building up the tax system in order to service large amounts of short term debt which had to be repaid after the wars (Saylor and Wehler 2017). Wars were in this view not only crucial for the rise of the tax state but also for the modern state (namely the rise of mass income taxes).

The problem with the war-taxation thesis is that its explanatory power was limited to the European state building history. In fact, war did not make states in Latin America. States were the result of the colonial independence in a particular post-colonial society. Scholars thus explored why the war–taxation nexus did not materialize in post-colonial countries in general and Latin America in particular. The answers where diverse: Some claimed that the frequency and depth of wars was not given in Latin America. More fine-grained explorations however showed that some wars indeed were very costly for Latin American countries and posed a significant revenue raising effort for these countries. In addition, after wars – for example such as the War of the Triple Alliance – countries had accumulated significant debt which needed to be repaid. Authors suggest that the war-taxation nexus did not apply well in Latin America because rulers had access to alternative sources of public finance. Access to foreign

credit provided an easily available alternative for states elites to access finance without increasing taxation during war times (Centeno 1995), and thus a consistent built up of the Latin American tax state was postponed.

Contemporary research follows this idea but frames this failed war-state nexus as a voluntary decision of Latin American governments. It was not only that credit was readily available but also that ruling coalitions in Latin American countries, dominated by landed elites, favored rising debt levels over increased taxes, because of their ability to resist or take advantage of structural adjustment policies, like inflation. Thus, the internal power dynamics between elite groups explain the deliberative policy decision of governments to favor debt taking over the strong taxing institutions after war (Saylor 2015).

- *Economic dependency and post-colonial internal conditions*

The focus on the link between - what economists would call - the distribution of factor endowments, power relations in Latin American society and taxation is also the principal idea of scholarship which explains the unfavorable tax system development with the economic dependency or the post-colonial legacy of Latin American societies. This research also connects to the principal idea of dependency theory which stated that economic development of Latin American countries was frustrated by their specific insertion into the global economy as exporter of primary goods (commodities), resulting in negative terms of trade and a comparative disadvantage against their industrialized trading partners but also the social relations which resulted and were re-shaped by this economic insertion set by history, namely elite dominance, persistent inequality and exclusive citizenship.

The negative influence of commodity dependence on tax systems is present in contemporary research of the challenges to tax extractive industries and to fiscal sustainability (see Unit 10) as well as in standard textbooks of Latin American economic history (Bértola and Ocampo 2013; Blumer 2003). Most prominent, however, are two strands of reasoning, the resource curse literature, which states that rent generating export commodities (minerals or oil) dissuade the built up of the tax state and state building in general because they provide revenue windfalls. Rulers can satisfy their revenue needs without building an effective taxation apparatus, which would extract sufficient revenues from the society. but instead choose to use resource rents. In contrast to nonrenewable resources (oil, minerals), agricultural commodities are more auspicious for state building, since they arguably force the creation of greater extractive capability (Dunning 2008; Karl 1997, Ross 2001). Even so, all commodity exports can be taxed easily at ports, if not at the point of production. Such easy revenue is also said to enable fragile state building, including a weak tax state, among primary commodity exporters in general particularly compared to their resource-scarce counterparts (Doner, Ritchie, Slater 2005) (see also Unit 10). The resulting fiscal dependence on volatile commodity revenues makes countries more vulnerable for the future and unable to confront economic booms and busts with sound fiscal policy.

The second strand of research points to the social relations inherited by the colonial period, namely the high levels of inequality. Such research explores how being a colony strongly

influenced mediating institutions such as schooling, suffrage and/or land distribution and thus created “paths of institutional development” detrimental to economic development. With respect to tax policy, Sokolof and Zolt (2007) in a seminal article, look at the impact of social inequality inherited by the colony on tax system development. Comparing the tax systems of Latin America with their North American counterparts, they find that “the initial distribution of wealth, human capital, and political influence seems to have had a profound impact on how tax and other government institutions and programs evolved” (p. 205). The principal mechanism behind this is that progressive tax and expenditure policies were obstructed at the local and regional level in Latin America due to high inequality and elite dominance. This stands in contrast to what happened in North America, where more egalitarian societies implemented progressive taxation and expenditure at the local and regional level. In Latin America, by contrast, inequality led to regressive tax systems and low levels of redistributive expenditure policies, thus perpetuating inequality. This focus on social configurations, especially the role of elites and their influence on tax policy, are discussed more thoroughly in Unit 4.

Group work exercise:

Divide the class in n groups of n students. Each group should have minimum of 2 and maximum of 5 students. Each group is assigned on of the following texts week ahead of class: Schneider 2012; Centeno 1997; Saylor & Wheeler 2016; Mares & Queralt 2015; Wagner 1890; Seligman 1931; Sokoloff & Zolt 2007; Rostow 1960. The groups should read and discuss the text within the group. In class, they should give a short (5-8 min) presentation summarizing the main argument of the text. Emphasis should be given on a graphical display of the main argument using an arrow diagram or other forms of visualization. They also should give attention to the methodological strategy pursued in the contribution and the use of empirical data.

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Unit 3: Taxation and State Capacity, Representation & Welfare

Unit 2 introduced the importance of taxation for state building processes in Europe and Latin America. We have seen that taxation is central for the rise of bureaucratic administration, the legitimacy of the state and the allocation of public and private resources. This unit reviews the inter-relationship between taxation and the state and presents theories and perspectives for nexus of taxation and (a) representation and political institutions and (b) state and bureaucratic capacity.

Learning goals:

- Students will become familiar with of how taxation is related with regime type, representation and state capacity.
- Students will be able to apply the idea of fiscal contracting to explain tax regimes and tax dynamics.
- Students will theorize about the effects of taxation on state capacity and the welfare state.

3.1 Taxation and regime type and capacity

One of main ideas of the historically centered literature discussed in Unit 2 was that taxation was a central part of the building of the modern nation state. Several authors claim that thanks to taxation, rulers were obliged to build modern bureaucracies and thus set in motion a state building process leading to states based on a rational-legal organization of public life. Within this literature, some authors did not only claim that taxation was central to the rise of the nation state, but was also a determinant for the form of government. Central idea is that for reaching (quasi voluntary) compliance of citizens to pay taxes, governments had to offer not only public goods but also representation. The popular slogan “no taxation without representation” expresses this idea to the present day. Based on the story of European state building, authors claimed that increasing taxation and increasing democracy thus go hand in hand.

In the contemporary literature, this idea is present in writings which investigate the connection between taxation and regime type. The principal hypothesis is that a) democracies are likely to tax more and b) because, democracies increase the incentives for politicians to engage in winning the vote of the majority democracies will tax more progressively (i.e. tax the rich more heavily). Comparative large-n research on this topic, however, does not completely confirm this claim. Several factors may influence the taxation-representation nexus: a) access to rents from non-renewable resources may defer governments from bargaining with citizens b) the quality of democracy matters c) several other factors may influence the tax level (crisis, composition of the economy) d) with respect to the second hypothesis about a more progressive tax mix, progressive taxation may be circumvented if welfare spending is progressive, or if the claim for pro-progressive vote is ruled out by conservative votes which can better rally support for other issues (religion, etc.). Nevertheless, some comparative studies did show that regime type may have statistical

relevance, but that not democracy but the degree of liberal rule is crucial. The statistical work by James Mahon (2005) reported in Section 2.2 points the same way: the dependence of contemporary governments on general taxation is more strongly associated with liberal rule (i.e. institutionalized constraints on state power) than with democracy.

In this line of research, some scholars, however, have pointed out that the direction of the taxation-representation link may be reversed. For example, Boucoyannis (2015) claims that representation occurred first in states with a well-developed state and tax capacity. This suggests that societal demands for accountability and better governance are more likely to emerge in response to tax regimes that are already effectively applied. However, the reverse has not been found to apply.

A second prominent strand of research connects taxation with state capacity. This literature, also a result of the works on European state building literature, claims that taxation is a central measure for the capacity of the state. Capacity here is frequently linked to the definition of “infrastructural power by” M. Mann (1984). Infrastructural power of the state is central to penetrate society. In this concept, taxation is seen as a central aspect because it can show the extractive power of the state, i.e. the capacity of the state to extract revenue from citizens, for example elites. Several works thus used measured of taxation (tax/GDP, tax ratios, tax mix) as a proxy for state capacity (see Unit 4), not least because tax data is one of the oldest available data for countries around the world.

Contemporary scholarship in Latin America highlighted the fact that the expansion of VAT during the 1990s has improved the administrative capacity of the Latin American states (Mahon 2004; Bird and Zolt 2015). State capacity, in turn, has been seen to affect effective tax extraction, while low levels of extractive capacity feed back into low levels of state capacity (Centeno 2002; Kurtz 2013; Soifer 2013).

3.2 Taxation and the welfare state

A second research topic is the relationship between taxation and welfare politics. With the challenges of the welfare state in Europe from the 1980s onward, research on social policy and the welfare state expanded. Authors defined types of welfare states (or worlds of welfare) accounting for the important differences within industrialized countries (see e.g. Esping-Anderson 2013), or connected these social policies to varieties of capitalism they identified to be present around the world. With the rise of globalization (see Unit 8) and rising fiscal deficits after the 1970s, the question of welfare financing and thus taxation was back at the table.

Some scholars argued that types of welfare (and their evolution) can be explained by different patterns of tax system development. For example, it was argued that liberal welfare states have more progressive taxes than the conservative and social democratic welfare states (Wilensky, 2002; Kato, 2003; Lindert, 2004). Kato (2003) also argued that countries can only develop large welfare states if they first adopt regressive taxes. The prime example is the

USA, which adopted income tax as its major form of finance before the First World War, and because it resisted the VAT on several occasions, the financial basis for the welfare state was undermined (Morgan and Prasad, 2009). However, the sequence is not clear, since either the decision to adopt regressive taxes preceded, and enabled, the growth of the welfare state or policy-makers adopted regressive taxes because they wanted a form of finance that would allow the state to grow (Ganghof 2006, Lindert 2004).

In any event, the tax mix is seen as determinant to the development of the welfare state in times of increasing globalization. The argument is that regressive taxation keeps the wealthy on the side of the welfare state and allows them to consent to within-class redistribution (Wilensky 2002). Meanwhile, progressive taxation raises frequent conflict over revenue generation (Prasad 2006) and thus puts the welfare state in question. As tax systems in Europe, shifted to rely on indirect taxation, authors argued that this was the reason the resilience of European welfare states in the face of globalization (Hays 2003). A ‘race to the bottom’ could be avoided because welfare states were financed with forms of taxation that were not subject to global competition, specifically, taxes on labor rather than capital (see Unit 8). In Latin America, the development of the welfare state was less successful and exclusionary welfare states are present until today. Research that aims to link the development of the welfare state and taxation is still rare for the region but some studies suggest that this may have to do with the frustrated expansion of taxes (principal income tax) from a class-based tax (paid only by the wealthy) to a mass-based tax (Biehl and Labarca 2017) and thus private-financed insurance schemes (instead of state-financed) remained important, especially in the rural areas.

3.3 Fiscal contracting

Several political scientists make reference to the contractual nature of taxation. As discussed in Unit 4, taxation can be framed as a contract between individuals and the state (rulers and the ruled). Joseph Schumpeter, one of the first to highlight this idea, already posed the question the “fiscal contracting” literature later aims to answer:

- Which particular form does the bargain over this contract take and which players are relevant?
- What factors are most important to explain the outcome of (tax) bargaining?
- How is the contract maintained, or what sustains taxpayers’ consent to be taxed on an ongoing basis?

As drastic changes in modern tax systems (in the level of taxes collected as well as the tax mix) seldom happen overnight and significant changes are more due to long term processes, authors have suggested that taxation can be framed as a self-enforcing equilibrium, particularly if different countries are compared with each other.

‘Fiscal contractualism’ suggests that taxation rests on a contract between citizens and governments. The idea of the contract supposes that no actor can make a unilateral decision to

alter the contract (in a sustainable way) but has to negotiate with the other. Typically, scholars propose some solutions to change the fiscal contract:

- “tit for tat”; or compensation: citizens pay more taxes if they have a clear and identifiable increase in service (Timmons 2005);
- Change in initial conditions: the power relations which underpin the bargaining alter dramatically (war, revolution);
- Increase in the number of players: another solution would be to increase the number of relevant players. For example, governments may be able to rally support by external actors (IMF, etc.) or strong civil society groups and thus increase the pressure for change;
- Increase the bargaining issue: Another common strategy to negotiations is to increase the value of what is at stake. For example, governments, may link tax increases on the wealthy with incentives in other areas (deregulation in specific sectors);
- Create credible channels of bargaining and credible commitment: There is an argument in the literature that political institutions which accumulate political interests (strong and stable parties) on the state side and coherent encompassing business organizations on the other side are decisive for the elite/business side. Other “organizational” forms are conceivable (based on culture, ethnic cleavage, etc.);
- Overlap between political and economic interest. For example, the ruling coalitions of the 19th century in Latin America.

Important to mention is that a successful bargain may not always mean more taxation and especially more progressive taxation, as the fiscal contract ultimately depends on the mutual interests of the parties involved.

The crucial question is what defines these long-term equilibriums, and thereby explains the existing variation in tax composition among developing countries. Three arguments have been put forward:

- Administrative and capacity constraints: For example, if “hard to tax” sectors exist, government and administration is seen as weak, or when bureaucratic quality is weak it is assumed that indirect taxes would be favored over direct ones.
- Incentives for governments to tax more (political will): For example, some authors have argued that political considerations can shape the decision of political actors. A classic idea is that democracies are likely to tax more and more progressively, i.e. that regime type matters for taxation. However, in Latin American countries, formal political institutions (which are the ones likely to be measured) are frequently less important than informal ones in the policy process.
- Elite and the state: elites are principal actors when it comes to taxation in “developing” countries (see Unit 6). Elites concentrate economic, political and social power and they are likely to see their interest threatened by higher taxation.

Some authors argue that elite cohesion is decisive. The argument: more cohesive elites are more powerful to resist. Others argue, in contrast, that more cohesive elites are more likely to be a credible bargaining partner, if a credible actor on the political side exists as well (for example stable political parties, or if interests align, etc.) and compromise or identification is more likely, e.g. trading higher taxes for other state-financed benefits.

3.4 Political ideology and tax systems

One particular strand of the taxation – state literature is research on the question of whether taxation is shaped by ideological preferences. For Latin America, this is still an emerging research field. The principal claim is that parties with a certain ideological preposition – e.g. “leftist” orientation – favor distributive policies, and thus take a pro-tax stand. There are several challenges to such research. First of all, in many ways so far research on ideology and taxation is very much inspired by crude one-to-one application of European concepts and categories. This is the case with the scales by which the ideology of political parties or political actors is measured, as well as the categories used themselves. Political parties in Latin America are difficult to compare to their European counterparts, and their frequently decentralized party organizations, personalistic features or clientelism may out rule ideological concerns as a centrifugal force. Informal politics and informal bargaining often count more than formal decision making processes within political parties. However, new studies based on expert surveys, for example surveys among parliamentary elites (PELA, project by the University of Salamanca) present alternative measures of ideology. The result is mixed at best: Some studies find that ideology influences local government expenditures but not taxes, or that left governments collect more revenue than right governments from business taxes, but less revenue from property taxes, or that left-leaning governments are more likely to implement tax reforms that seek to increase taxes, and, in particular, income tax revenues.

Group work:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if there are more groups than countries, groups can select other Latin American countries). The task for each group is to develop a map of actors relevant for tax policy in the country. Based on their own research from available sources, the group should visualize the relevant actors and their positions towards tax policy. Actors may include political parties, social organizations, business groups, worker unions or other forms of organized interest. Groups should present their results in front class. This group work can be connected with later group work, namely in Units 4, 6, 7, 9, 10, 11, 12, and may provide the first step of an encompassing analysis of the taxation in the country in question by the group.

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Unit 4: Fiscal Sociology: Taxation & Society

Taxation has not only been the domain of public accountants, quantitative economists or tax lawyers but also a principal object of interest in sociology and classical political economy. This sub-discipline called *fiscal sociology* has regained considerable attention since its rise in the early decades of the 20th century and its decline in the middle of the 20th century. Fiscal sociology aims to explore the relational dimension of taxation. The basic concern of this approach is how tax systems are shaped by society and society (and social change) is shaped by tax systems. This unit provides an introduction in to the basic ideas of fiscal sociology and highlights its main themes. Special attention is given to the role of elites, one of the principle topics in the literature on Latin America. Note that the main ideas of fiscal sociology school have informed various other aspects studied in other units, regarding normative debates, tax compliance, direct taxation and tax reform (see Units 2-9).

Learning goals:

- Students will learn the fundamental ideas of fiscal sociology.
- Students will be able to use tax indicators as indicators for social change and know about the virtues and limits of such indicators.
- Students will theorize about the social effects of taxation and how taxation may be related to other social phenomena.

4.1 Principles of fiscal sociology

The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare – all this and more is written in its fiscal history, stripped of all phrases. He who knows how to listen to its message here discerns the thunder of world history more clearly than anywhere else.” (Joseph Schumpeter [1918] 1991)

In Unit 3 we have seen that taxation is central for the powers and legitimacy of the state; the allocation of public and private resources and the rise of bureaucratic administration. Many sociologists today however are rediscovering the importance of taxation not only for these state-related aspects but as a central aspect of modern societies in general. For fiscal sociologists, taxation is more than a revenue collecting tools. As Martin, Mehrotra, and Prasad state in the introduction of a book on the “new” fiscal sociology in 2009: “taxes formalize our obligations to each other. They define the inequalities we accept and those that we collectively seek to redress. They signify who is a member of our political community, how wide we draw the circle of ‘we.’ They set the boundaries of what our governments can do. In the modern world, taxation *is* the social contract” (2009:1). Along the lines of the above quote of Joseph Schumpeter, the founder of what is now called fiscal sociology, taxes are seen as central to understanding modern societies but also are highly important because they in turn influence modern societies in various – and some authors even claim in all - aspects.

The relational perspective of taxation was first expressed most clearly by Joseph A. Schumpeter in the beginning of the 20th century. His idea, very much part of a more general debate about the social, economic and civic role of taxation (among others with important contributions by the Austrian Marxist Rudolf Goldscheid, Max Weber, and others) was based on a classical political economic perspective, combining the social, historical, political and economic spheres of life. Schumpeter proposed to see taxation as a “symptom” and a “cause” of large-scale changes in the economy and society (see also Martin, Mehrotra, and Prasad 2009). He claimed that “The public finances are one of the best starting points for an investigation of society, especially though not exclusively of its political life” ([1918] 1991: 7).

4.2 Taxation as an indicator for social change

After Schumpeter, several scholars treated taxation as a symptom or an indicator of social change. For example, it can indicate to what degree taxpayers consent to pay taxes and thus accept the state that they are living in, or in other words, how much they accept the state as the legitimate order that they are living in. It has also been taken to indicate the degree to which capital owners or the rich are taxed, which in turn could be interpreted as a measure for the value, desire or acceptance of a more egalitarian society and the capacity or power of the state to extract resources. To the present day, tax data is used as an index for different concepts like democracy, capitalism, the rise (see Unit 2) and fall (see Unit 8) of the state or the modernization of society. Using tax data as a proxy for these phenomena may not always be convincing on its own but there are good reasons to use taxation as an indicator in large scale analysis. One of the most important is that tax data is largely available, has historical depth and is comparable across time and space. Within working groups in this course, the relevance of tax indicators, their influence and use should be critically discussed (see group work).

4.3 Taxation as a cause of social change

The second Schumpeterian idea, that taxation is also a cause of social changes only recently has been re-explored. Scholars of what some have claimed “new” fiscal sociology argue that for several reasons taxation ‘has also a theoretical or causal importance for modern life, because (Martin, Mehrotra, and Prasad 2009: 3-4):

- “Taxation establishes one of the most widely and persistently experienced relationships that individuals have with their government and – through their government – with their society as a whole. This makes taxation a crucial element in the development and formation of the society into an ‘imagined community’ (Anderson 1983) of the modern nation-state. Taxation enmeshes us in the web of generalized reciprocity that constitutes modern society.” (p.3)
- “Taxation establishes a dynamic relationship between the taxpayer and the state, in which there always exists a potential conflict of interest. The state, the very guarantor of social

order in the modern world, depends on a relationship that always contains the latent possibility of conflict and disorder.” (p 4). This is the reason why most authors in the field of fiscal sociology speak of (temporary) fiscal contracts when they describe a particular state of a tax regime. These contracts are the (temporary) outcome or result of this conflictive bargaining relationship.

- Taxation is not comparable to other sacrifices (e.g., compliance with traffic laws) or state extractions (e.g., conscripted military service) that the state demands from its citizens. This is because at the very heart of taxation lies the idea that taxes are, and should be, paid without receiving a concrete service in return: “The resources extracted through taxation are exchangeable for other resources; they make possible not just one state action, but most if not all of the state’s activities. And the more extensive the activities of the state, the more extensive the reliance on taxation – and the broader the potential ramifications of changes in tax policy [...] In modern states, therefore, taxation is not only a dynamic, potentially conflictual relationship, but one whose changing forms may have potentially far-reaching implications. The taxpayer’s decision to evade or resist taxation may challenge the existing social order, as well as the very basis for enforcing social order – in a way that decisions to evade or resist speed limits, social policies, or sumptuary laws do not. The state’s mode of establishing and enforcing taxation may shape the social order in its turn.” (p.4).

Identifying taxation in this relational dimension (as cause and symptom) has led scholars to question several common understandings, for example of the origins of Western democracy, the welfare state, civil war or ethnic conflict, the extension of democracy, the formation of the family, the perpetuation of gender relations, or other social outcomes. However, the research in fiscal sociology which investigates the second Schumpeterian claim (taxation as cause) for Latin America is still following in its footsteps and much is left to be explored (Atria, Groll and Valdes 2017). Until now scholars have not found compelling answers to one of the wider questions Schumpeter already had raised in his work: how did taxation and the particular fiscal bargains which it represents affect civilizations, cultures, and “forms of life” (Schumpeter [1918] 1991: 100)?

Nevertheless, one of the most important and fruitful contributions of fiscal sociology to the Latin American tax debate is the focus on elites and taxation. Already in the work of Schumpeter, taxation was framed as an (existing) social contract. This contract was the result of a historic bargain between rulers and ruled forged in a particular time and place. His interest was then to explore several key questions about this contract. For example, the particular forms of the bargain, how the bargain is maintained, or the causes of what sustains the taxpayers’ consent to be taxed on an ongoing basis (Schumpeter [1918] 1991: 100)?

This idea, that tax policy was basically an “elite affair”, or in classic terms a struggle among classes, was also present in the writings of Weber, Marx, Engels as well as Rudolf Goldscheid. Weber went so far to claim that modern democracies were more and more cautious toward the propertied classes “because governments increasingly must compete with

one another to attract a tax base of mobile capital” (1968: 352). Later Margaret Levi’s (1988) seminal study emphasizes how rulers use norms and ideology as a means to motivate tax payment through quasi-voluntary compliance. But in general, Latin American elites have not pressed for robust tax systems (Centeno, 1997). Within the region, Soifer (2015) highlights how varying elite ideologies produced divergent fiscal systems in Chile, Colombia, Mexico, and Peru. Schneider (2012) similarly points to differing levels of elite cohesion and dominance to account for variation in Central American tax regimes. Finally, Lieberman (2003) offers a cross-regional analysis of how the elite’s racial and regional attachments influence fiscal policy. Each of these studies highlights how elites and broader social currents combine to chart the fiscal course of Latin American countries. The role of elites is central to understanding taxation in the region and we will therefore address their role in several other units (Unit 2; 5; 6; 7; 9).

Group work:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if more groups than countries, groups can select other Latin American countries). The task for each group is to interpret as much as possible social phenomena via tax indicators (with the help of taking a look into the literature). The groups should discuss which indicators are useful and why, what they can explain and what not, and which alternatives may exist. Students should present their findings in the class.

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Unit 5: Justice, Ownership and Taxation

This unit reviews taxation from a moral and philosophical point of view. Being one of the most fundamental and influential institutions in all modern societies taxation raises normative, ethical, and moral question. All discussions and designs of taxation and specific taxes are connected with assumptions about what is just and morally right. Take for example the debate about whether taxation should help to redistribute income. How can a tax system be justified in which richer people pay more taxes than poor people?

Answers to such questions do not refer to technical aspects or abstract economic models alone. They also embrace moral standpoints about underlying concepts which are connected with tax matters. For example, a morally grounded answer to the above question would entail specific ideas about the role of the state (do we favor an interventionist state or a state which is limited to its basic functions?); our conception of property and ownership (is private property to be protected by any price?); the idea of citizenship (are tax payers part of the political community and thus bearers of rights?); and of our idea of justice and fairness (what is a just society and how should we reach it?). All of these topics have been subject to their own extensive and ongoing philosophical, moral and normative debates. This unit will not dwell on these debates but instead introduce the principal moral arguments surrounding taxation and its underlying concepts. It also presents modern movements that advocate for more justice and fairness in taxation in Latin America and beyond.

Learning goals:

- Students will become aware of the moral questions and grounding concepts which underlie taxation and tax design.
- Students will understand the concept of tax justice and be familiar with moral perspectives and foundations of taxation, ownership, justice and fairness.
- • Students will be able to reflect on and analyze current tax systems in Latin America in terms of justice.

5.1 Moral and philosophical issues of taxation

Taxation is one of the fundamental mechanisms the state imposes in society and establishes a very personal relationship with citizens in taking away part of their private property. However, the extent and depth of this intervention is highly disputed. Such disputes are not only motivated by private interests but are also influenced by moral views. Moral and ethical considerations can not only guide taxation and tax design; they may also help to increase the public acceptance of taxation and decrease tax avoidance or evasion. This is important as the good functioning of a tax system also depends on the tax behavior of individual taxpayers, which importantly depends on their moral view of taxes. Finally, in tax policy debates, moral and ethical arguments can play an important role to rally support or legitimate arguments, although frequently they are not spelled out clearly. These are all reasons why ethical, moral

and normative question related to tax systems have their relevance and are of importance beyond the limited role they are assigned in the quantitative public finance literature.

Several topics have been widely discussed in the literature and engage in this discussion. One of the most important is the question of tax fairness: Who should pay taxes and how much? Tax fairness often is related to ideas of justice. Often we assume that if a tax system is just it is also fair. But what is a just tax system and what is our conception of justice? As Geisenbauer et al. (2015) argue that an answer to these questions would entail discussion at several levels:

- What is the justification of taxation as such and what role should taxation play with respect to social justice?
- How should the tax system and particular taxes be designed to be just? For example, specific taxes, like wealth and inheritance taxes maybe especially useful to contribute to social justice but they are also the most contested.
- Following the discussion in Unit 8, what is the global level with respect to justice?

5.2 Fair and just taxation

Moral aspects of tax fairness include two questions (see also Geisenbauer et al. (2015)). A general question which can ask whether taxation is generally justified and a given tax burden is just. A more specific one which asks if a given tax burden is fairly distributed among taxpayers. Two opposing concepts have been put forward to provide answers to both of these questions, the benefit principle and the ability to pay principle:

- (a) **The benefit principle:** The benefit principle is said to first being formally theorized by Adam Smith in 1776 and is well connected to contractual social theories. The idea is that taxes are the price citizens have to pay for the use of public services which are rendered to the public, i.e. to the direct benefit of the individual. Citizens thus should only pay as many taxes as are necessary for the services they receive and take advantage of. The benefit principle has a contractual root as it combines the revenue raising side with the spending side. However, this idea also implies that citizens should not being taxed for services they don't want or need. Public choice authors argue moreover that this idea gives strong incentives for taming a possibly overarching state – or leviathan state - and is thus best suited to secure democratic standards (i.e. the prevention of state tyranny). The benefit principle does support some redistribution via taxation, but it is not the proper role of the state to interfere in the property of citizens without offering a service in exchange and citizens are assumed to be likely to take advantage of public services in roughly the same degree.
- (b) **The ability to pay principle:** The first formal theorizing of the ability to pay principle can also be connected with the writings of Adam Smith but also John Stuart Mill. The ability to pay principle rests on two main ideas developed in the late 16th and early 17th century: The idea of equal sacrifice (for a short discussion see Musgrave 1959) - if all citizens have equal access to public services then there is some equity justification for

asking citizens to make equal sacrifices in order to provide those services - and the idea developed in economics of the marginal utility of income: marginal utility is diminishing if a person gets richer because the needs/wants which are being met by additional income are less urgent than the basic needs that have to be met by earlier income. Thus, the utility of more income decreases with income. The resulting idea is that every taxpayer should make the same (absolute, relative or marginal) sacrifice. Redistribution via taxation would be legitimate and morally supported.

In contemporary tax systems, which are built upon a multitude of different types of taxes and not upon a single tax, the question is not too choose for one or the other principle but rather to ask which principle gives better answers to the detailed problems of (de-)legitimizing tax policy decisions on different levels.

5.3 Moral views on underlying concepts of taxation

The normative underpinnings of these two principles are not sufficient on their own to build an elaborated theory of taxation and social justice on them. Authors therefore frequently connect tax matters and specifically these two principles with a clarification of underlying concepts. Of course, a close revision of a tax system may turn this perspective upside down: via the analysis of taxation we may infer the dominant and collectively shared view of the underlying concepts held by society and government. Some of these concepts can be:

- *Normative ideas on the state.* Moral tax reasoning should make an argument concerning the concept of the state. The state may be seen as a technical instrument to realize tax justice considerations, but it is never simply a neutral ground where tax ideas compete and the best one wins. Statehood and taxation are narrowly intertwined, and so are taxation, poverty alleviation and social justice.
- *Citizenship:* Citizenship regimes define which persons are recognized as legitimate political actors, bearers of rights and responsibilities before the state, and able to use mechanisms of participation in the public and political process in a society. Taxation is directly related with citizenship regimes as the ability to pay as well as the benefit principle relates taxation to state services. Now the question arises if taxes are paid by foreigners, what citizenship status should these persons be granted? Or if there is a certain citizenship regime, e.g. an idea of equal citizenship, how can the tax system contribute to this idea?
- *Property & Ownership:* Taxation directly affects private property. More radical liberal and libertarian concepts of property would state that state intervention should be limited to a very minimum and private property has to be protected. A historic argument is that property and wealth distribution is an expression of the natural order of things and should thus be maintained. An example is the Edinburgh-rule of 1833 which stated that taxes should not change the relative position of taxpayers, instead, to ‘leave them as you find them’, neglecting ethical and political claims for progressive taxation by portraying all redistributive effects of taxation as unjust. More modern libertarian positions modify this point but also entail an anti-interventionist stance. Take the influential writing of Robert

Nozick (1974) who proposes a rights-based libertarian view and a neglect of distribution via taxation.

In contrast, there are also radical redistributive claims and social constructivist views on property. The principal idea is that property would not be possible without a legal and political framework including the idea of property and property rights which enables economic activities and network formation. The frequent claim that taxation is evaluated against changes in property is thus misleading, as it is property which would not be possible without the very legal and political systems taxes are financing. In the words of Murphy and Nagel (2002: 8) “Private property is a legal convention, defined in part by the tax system; therefore, the tax system cannot be evaluated by looking at its impact on private property, conceived as something that has independent existence and validity. Taxes must be evaluated as part of the overall system of property rights that they help to create”. Such views would thus help to legitimize property taxation.

- *Social Justice and Equality*: An assessment of whether tax systems are fair and just also has to be made against the ideas of equality and justice. What is just and what should be equal and how such equality and justice should be pursued is subject to intensive moral and normative debates. Most prominent ideas include liberal ideas of equality, e.g. by John Rawls or communitarian proposals, e.g. by Michael Walzer or radical libertarianism, e.g. by Robert Nozick. These are lively, ongoing and very relevant debates which can shape the moral assessment of taxation.

5.4 Global tax fairness

In a globalized world tax matters also have an increasing transnational dimension. All aspects of this transnational dimension of taxation, including tax havens, the difficulty of adequately taxing international corporations and capital, issues of international tax competition and ‘location factors’, the lack of transparency in global (legal and illicit) financial flows and the lack of global tax governance have important ramifications for tax justice as well as for addressing questions of global and local poverty and justice. However, frequently debates on tax justice are limited to a conception of social justice within a certain (national) political community or nation state. Most recently there is a growing debate about global tax justice and how this could be reached (Pogge and Krishen 2016). This debate is also very much present in the work of several non-governmental organizations in the Americas. Some of the publications of these groups are included in the literature.

Group Exercise:

Students write, after a group discussion, a ‘four minute’ paper on the topic “What are just taxes?” Guidelines of the exercise: After a discussion in small groups or in plenum

- 1) Students are provided with a blank piece of paper
- 2) One minute is given to the students to elaborate arguments in a graphical form, e.g. Via a mind map, etc.
- 3) Two minutes are given to write down the argument and a discussion of the question. Students are advised to leave a 3cm space on the right side of the page
- 4) Students are given one minute to revise their text and highlight corrections or changes in the free space on the right side of the paper. The final product of the exercise should be a one/two page text.
- 5) Students hand the paper in to the professor. In the following session, the professor summarizes the most important points made in the student papers and highlights best practices.

Idea: This is a hands-on writing exercise and can be used in any circumstances related to writing blockades, etc. Time pressure is crucial for the success of this exercise.

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Unit 6: Tax Policy and Reform in Latin America

The analysis of tax reform is a principal issue of interest in political science. This unit teaches the most salient theories applied to tax policy reform in Latin America and beyond. Most of these perspectives draw on theories of policy reform (veto player theory, electoral and legislative politics, interest and partisan politics, elite politics, etc.) which are widely applied in other areas of public policies. By reviewing these in the context of the Latin American tax reform experience, students get to know the most important actors, factors and structural (economic) variables which impede or enable tax reform in the region. As the reform experience in Latin America is heterogeneous, diverse and voluminous, this introduction does not pretend to provide a complete empirical summary of tax reforms in the region. Instead, the arguments which have been developed to explain reform outcomes are at the center of this unit.

Learning goals:

- Learn basic concepts of policy reform process (policy process, veto player, interest groups, etc.) and their application to tax reform.
- Understand and know the main arguments to explain tax policy reform in the region.
- Be able to analyze a policy reform experience in a Latin American country with the concepts and theories learned.

6.1 Tax reforms: What is studied?

Before summarizing the most salient theories of tax reform it is worth mentioning some general differences in these studies. Frequently, tax reform is analyzed as a dependent variable (i.e. the goal of studies is to show what explains the failure or success of reform initiatives). However, what tax reform is and how it is measured also differs in the literature and thus impacts the analysis.

In accordance with other analyses of public policy, the starting point of most of the reform literature is the passage of a law via the legislative or executive bodies. Frequently, studies are not interested in the mere passage of a tax reform but also provide a description of the content, e.g. how the reform aims to overhaul the tax system, improve revenue collection, enhance tax equity, or a combination of these objectives. Yet studies may differ in how they assess these legislative intends:

- (a) Scholars following a legal positivist perspective take the intended effect, as established in the law, as the basis for their description of the reform. Frequently, scholars make a distinction between the effect of tax reforms on horizontal and vertical equity (see Unit 1), generalization of tax bases, tax mix or tax levels and rates. Indicators to describe the magnitude of reform initiatives are statutory or marginal tax rates (see Unit 1). The advantage of this approach is that a construction of large datasets of reforms for various countries and time periods (also historic) is possible, allowing large-n comparative and

cross-regional research designs and the application of quantitative analysis. However, the disadvantage is that the fiscal effects of tax reforms may differ from the desired ones as established in the law. The outcome of reforms is not always predictable and can be contradictory to the ones established in the law. Various factors can influence reform implementation and execution. This may include organizational features (capacity of the bureaucracy, etc.), “second-order effects”, e.g. the reaction of tax payers in the form of evasion, illusion or burden-shifting (see Unit 1, economic effects of taxes) or changing economic circumstances. In other words, changes in revenue collection and changes in the legal framework guiding its collection are not always directly the same.

- (b) An alternative approach to characterize tax reform is the description of the reform’s observed fiscal effect. For such an endeavor, in-depth ex-post analysis of revenue collection is necessary. As this approach may require significant knowledge of revenue data or even tax incidence analysis, the range of such studies is limited to a rather small-n research design, i.e. a few reforms in few countries. Studies draw on effective tax rates or incidence analysis (see Unit 1 and Unit 7) to understand the changes in revenue collection caused by legal changes. The advantage of this operationalization is a more precise description of the effect of the tax reform on revenue collection and the bottlenecks of reforms. The drawback of this approach is that, due to data constraints, even with a sophisticated analysis the precise effect of tax reforms is not always measurable and that it is naturally backward-looking. Therefore, most studies use this kind of approach in a simple way to confirm their classification of reform content via a legal positivist perspective.

Several explanations have been put forward to explain a) the passage vs. failure of tax reforms or b) the type of tax reforms passed. These explanations do not always aim to provide a general and unique explanation. Scholarship on reforms includes case studies, comparative case studies and large-n quantitative research. Reviewing the reform experience of Latin American countries, it is difficult to determine one single explanatory factor as the main cause of reform success or reform content. Rather, a combination of different explanatory factors may provide the most sufficient framework to explain most reforms or reform outcomes (for a reform reviews see Mahon 2004, Bergman et al. 2016, Bernardi et al. 2008). In general, one may distinguish among explanations according to their focus on different aspects such as the behavior of relevant actors, structural or economic factors, institutional and legal processes, collective or discursive influences or a mix of these aspects to explain policy outcomes.

6.2 Tax Reform and structural economic factors

Reviewing the history of tax policy reforms in Latin American, the frequency of reforms in specific economic and social contexts deserves special attention. Structural policy reforms appear to be more frequent in times of economic, fiscal or political turmoil. In addition, Latin American economies share some common characteristics which are said to impact reform design, likelihood and outcome. Latin American economies have not only evolved cyclically

– following periods of boom and bust – but are also marked by high inequalities; high concentration of (productive) capital and high levels of market concentration.

It is considered common knowledge that capital in Latin America is (although to different degrees) scarce, mobile and highly concentrated. High concentration of income, capital and wealth poses an important challenge for Latin American countries to impose reforms which aim to raise additional revenue (see also Unit 2), for three reasons:

- (a) High income inequality shrinks the tax base for income taxes. In addition, it poses a threat to the social contract and the willingness of contributors to pay. Upper middle and top income groups are taxed proportionally higher while they receive proportionally lesser benefits from services. As the relative contribution of the personal income tax to overall public revenues in Latin America remains underexplored this problem persists.
- (b) High capital concentration is also an important aspect to explain tax reforms as well as high levels of tax evasion. First, the tax morals of the top income groups are frequently weak due to the rationale explained above or due to other cultural, social, or historical factors. As high income groups also have preferential access to policy making (see next section) they may be more likely to block reforms. Secondly, tax non-compliance is frequent because the high concentration of capital at the personal or corporate level increases the benefits of evasion. Due to more possibilities to contract specialized service providers (consultancy firms, law firms, etc.) aggressive tax planning also becomes a feasible option.
- (c) A high level of capital concentration also puts governments in a less favorable bargaining position against corporate power and business groups (see next section).

A second important structural factor is the large size of the informal sector in most Latin American economies. Informality is a real obstacle for tax collectors. Informality includes unclear property rights, additional costs for control and enforcement and an unclear and unstable tax base. Frequently, informal businesses – a term which may include street vendors as well as large drug trafficking cartels or big corporations – are operating in informality because unpaid taxes are part of their business model or paying taxes would expose them to public authorities.

Thirdly, one of the most salient characteristics of Latin America economies over the centuries is the high volatility they face. Boom periods and crisis periods have closely followed each other and had an important influence on tax reforms in Latin America. Crises have a direct impact as tax bases crumble and governments face urgent fiscal needs and engage in short sighted tax reforms – favoring rapid revenue increases over long run fiscal sustainability. Indirectly, in crises, external lenders gain additional influence and press for ad-hoc tax policy responses to secure debt payments. Crisis times can also influence domestic actor constellations and the institutional setting (democracy or dictatorship) where tax policy is negotiated. At the conceptual level, Mahon (2004) argues that crisis and especially

hyperinflation creates expectations of widespread economic decline, which then increases the probability that political leaders will begin—and voters will approve—structural tax reform processes. Crisis in this literature is neither a necessary nor a sufficient condition to start reforms or explain its outcome. However, in specific circumstances it can be decisive.

Finally, exogenous economic factors also impact taxation in Latin America. The most salient feature is the intersection of Latin American economies into the global market. The historical pattern of exporters of primary goods as the dominant interface between Latin American economies and global market has up until the present day been the dominant feature of economies in Latin America (see Unit 2). As outlined in Unit 10, the effect of this historic reliance of commodity exportation is also reflected in the tax systems in the region, as tax and non-tax revenues from commodity production and exportation constitute a significant part of overall public revenues in most Latin American countries (see Unit 10). Tax systems in the region are therefore related to the overall characteristics of the countries' economies.

In addition, price hikes in global commodity markets can generate “unwarranted revenues” (Girouard and Price 2004) or windfall profits. Windfall profits are characterized by their disproportionate revenue-to-cost structure (Olsson and Dalgaard 2006), i.e. high amount of revenue with very low costs for raising revenue. Windfall profits in commodity boom times can significantly affect the probabilities of tax reform as the urgency for reform is obscured. Moreover, the political decision to engage in a certain economic development strategy, e.g. outward looking vs. inward looking, will impact the tax systems. For example, countries which ultimately adopted a very strongly outward looking development strategy like Mexico including the application of free trade agreements will face difficulties to raise certain taxes which contradict this strategy (see Unit 8). Finally, the ability to contract foreign or domestic debt has also been a frequently used mechanism used by policy makers to circumvent lengthy and difficult negotiations about tax reform. In other words, a given economic development strategy or paradigm plus a given global economic setting is likely to influence the selection of a certain kind of tax policy.

6.3 Actor centered explanations

Nevertheless, in a comparative perspective, even countries with similar economic characteristics and in similar economic situations have different kinds of tax systems, including tax levels and tax mix. This highlights the critical role of politics for taxation. The following explanatory frameworks have in common that they draw on the outcome of a political process which is said to be guided by the constellation and behavior of actors, ideas or beliefs or the institutional setting. This political process is thus frequently framed as a political bargain between political actors. Frequently, such actor centered explanations explicitly or implicitly frame actor's behavior in terms of rational choice, i.e. actors' behavior is following the maximization of their personal utility function (*homo oeconomicus*). They differ in certain key aspects such as the definition of utility, the question of where the most important bargaining takes place and which actors are relevant to explain the bargaining outcome. Different explanations for tax policy have been put forward:

(a) Policy process and veto player

Tax policy has been analyzed with classic theories of the policy process. Such studies explain the political outcome of a legislative process (here the passage of a tax reform bill) by theorizing upon the influence of competing actors at different stages of the policy process – agenda setting, policy formulation and passage and implementation.

A convenient explanation why tax reforms may pass and what influences their characteristics is the veto player theory (Tsebelis 2002). Veto player are those actors in the policy process with the capacity to veto a change of status quo. Status quo will be altered if the preferences of different veto players match (win set) and the veto can be overcome (analog to a bargaining game where all players must reach agreement). Depending on the analysis, the preferences of veto players can be deduced from their utility function, ideological stand, clientelistic relations, etc. Veto players can be framed along the lines of legislative politics, executive politics (veto power of presidents) or within informal politics. However, one weakness of the veto player theorem is a) the definition of veto players is empirically challenging, b) in political systems with important informal bargaining besides formal political processes, what constitutes a veto is not easily observable. Thus, the theorem runs into difficulties in explaining the content of reform outcomes if reforms are passed which do not match with the win set.

(b) Federal coordination and federal systems

For Latin American federal polities, explanations of tax policy outcome have emphasized the importance of federal coordination between government levels as an important explanatory variable for tax reform outcomes. Subnational executives (governors, etc.) can be important players in the legislative process due to their importance in electoral and party politics, especially in cases where a divided government (presidential party does not have the majority in congress) exist. Subnational executives (governors, etc.) try to avoid additional taxes levied upon their constituencies and thus may trade their reform support for concessions or benefits. E.g. neglecting the politically costly option of increasing the tax burden on their own electorate and instead prioritize the distribution of federal funds through revenue-sharing arrangements, or hindering the implementation of income taxes (Ardanaz and Scartascini 2013). Especially demos-constraining federal systems (Stepan 2004) with high levels (*malapportionment*) of subnational governments in congress, or universalistic legislatures (Inman and Rubinfeld 1996) can decisively influence tax policy and hinder ‘optimal’ tax system design.

(c) Electoral and partisan politics & legislative decision making

Other authors see electoral and partisan politics as the principal variable conditioning tax policy. Basic argument is that "the rules of the political game under which politicians are elected and hold office will condition every policy" (Tommasi et al. 2001). One of the most famous electoral-based theories, which comes from political economy, to explain policy

outcomes is the *median voter theorem*. It states that the government's policy decisions will – given a majoritarian electoral system - circle around the preferences of the median voter, within a one-dimensional spectrum of political opinion, as politicians want to secure the majority of votes and ensure their own re-election. For example, based on this theorem some authors argue that if inequality increases, voters would prefer higher taxes so long as these taxes are followed by state-enacted redistribution (Alesina and Rodrik 1994) and redistribution via taxation would therefore result from voters forming a majority that presses for progressivity. Although the theorem is simple and clear, the empirics of tax policy may be more complex. Either due to more complicated (mixed, etc.) electoral systems, multiple cleavages in public opinion and interests (Roemer 1998) or institutional characteristics of the legislative process (veto power, etc.). Furthermore, public opinion is not fixed but fluid and capable of being influenced (see next section).

Political parties and party politics are also said to have an impact on tax policy. As tax reforms have to pass congress, party politics gain importance in the situations of stalemates and conflicts in legislatures. Especially in Latin America's relative novel democracies party systems are weakly institutionalized due to electoral rules such as proportional representation and multimember districts, a mixed ideological base and heterogeneous constituents. Thus, frequently parties rely on forms of clientelism and personalism to build support and party systems are as a result fragmented, polarized, and volatile. Together with presidential political systems problems of deadlock between executive and legislature are common. A feasible way for executives to get tax legislation passed is therefore to obtain support from legislative allies in exchange for spending programs or tax incentives. This certainly affects tax policy outcomes, especially regarding the horizontal equity of taxes (tax exemptions, tax expenditures).

Finally, the decision-making process in democracies can be a relevant factor influencing tax policy outcome. For example, Steinmo (1989) argues that the structure of decision-making has definitively shaped tax policy in Britain, Sweden and the United States. Similar arguments are quite common among scholars studying decision-making processes in Latin America, where veto powers and excesses of presidential power have been observed.

(d) Ideology of ruling political actors, parties

Although party systems are weakly institutionalized and parties frequently lack a clear programmatic program, some authors argue that the ideology or political beliefs of governing political actors can nevertheless explain tax policies. E.g. Hart (2010) hypothesizes that, although multinational corporations place significant downward pressure on the corporate tax burden, the ideology of a country's ruling party is still a relevant predictor of taxation in the developing world. However, frequently this analysis is confronted with the challenge to classify political parties or leaders which do not neatly fit in a one-dimensional left-right axis in Latin America.

(e) Elite influence and business groups

Given the relatively low contribution of direct taxes to total revenue collection in most Latin American countries (see Unit 7) coupled with high income and wealth inequalities, scholars have paid special attention to the influence of elites and business groups on tax policy making. For these authors, tax policy is frequently an “elite affair”.

Economic elites are said to hold instrumental and structural power (Fairfield 2015). Structural power (Lindblom, 1977) of economic elites is higher if, due to capital concentration, the relevance of few economic elites and their companies in the domestic market is high. Economic elites can manipulate government with threats of de-investment, capital flight or reduction or dislocation of production against plans of increase in taxes. Instrumental power (Miliband 1969) describes the leverage of economic elites on government via direct mechanism. Instrumental power is higher if economic elites have a greater capacity to deliberately influence politics, e.g. via lobbying, direct participation in policy making, financing of parties and election campaigns, media coverage or other collective action like the support or initiation of protests and strikes. The higher the instrumental and structural power of elites is the more influence they have on tax policy and are thus likely to block or avoid tax policies, like higher income taxes, which run against their interests.

(f) Trust and Interests of Elites & Fiscal contracting

However, high elite power does not necessarily impose a particular kind of tax reform, including raising revenues of business and personal income. The fiscal bargaining literature – similar to the bargaining literature on legislative politics – argues that states can extract more revenue when taxpayers are granted representation or participation in governance or when spending benefits them directly (Levi 1988, Timmons 2005, Brautigam et. al. 2008). However, this general idea of fiscal contract (see Unit 4) runs into difficulties if taxable resources are extremely concentrated and governments need revenue to provide benefits for the broader society. In this case, offering elites greater political participation or material benefits in exchange for their tax-dollars may be counterproductive. For single case studies, authors thus have referred to factors that alter elite interests, like race and civil conflict. For instance, the wealth tax introduced in Colombia was explained with the presence of internal war (Flores-Macias 2012), due to the earmarking for military spending of revenues gained from this tax. Racial considerations and the threat of insecurity are said to have helped to obtain elite cooperation to tax reform that increased income taxes in South Africa (Lieberman 2003: 140-48). Other authors claim that trust plays a central role for elite cooperation. If elites can trust in the benefits of future government policies and have established positive relations with them, increasing elite contribution via taxes is possible and redistributive tax reform more likely (Schiller 2016).

However, the fiscal bargaining between elites and governments are also said to be influenced by the social and political context in which they happen. Governments can engage in several strategies to alter their chances for redistributive tax policy reform, either via the mobilization

of public support or moderating the antagonism against reforms from economic elites who are against redistributive tax reform and are likely to bear a higher tax burden. Two strategies are named in the literature (Fairfield 2013): a tax side strategy and a benefit side strategy. Tax side strategies exploit the possibilities of compensation within the legal margin of tax legislation, e.g. via tax deductions or discursively obscuring incidence and impact, etc. Benefit side strategies include compensation, earmarking or discursive strategies which highlight stabilization or link tax increases in popular benefits.

(g) *Networks and intra-organization of business and organized capital*

In sum the literature addressing elites and taxation contributes to the explanation of why taxation in Latin America is still comparatively low and biased towards indirect taxation. A certain shortfall is that this literature takes less interest in the organizational features of elites provided in the elite literature. The organizational capacity and characteristics however are well treated by scholars focusing on the influence business groups on tax policy. Business groups are said to represent the (accumulated) interest of economic or corporate elites. This literature claims that if business interest groups are centrally coordinated they will have significant organizational resources and leverage to block or at least soften tax reforms which are against their interest. This is because they can solve an internal free-rider problem (Castañeda 2016), i.e. part of the business groups will support reform if they are compensated otherwise and threaten thereby the common front of business against reform. The influence of centralized and well-integrated business groups is enhanced if there is an ideological convergence between these groups and the political actors engaging in the reform. The lowest influence can be found if business groups are decentralized and the agenda setters in the government do not share the same beliefs about tax policy.

This literature in a certain way draws on the network character of elites. Network theorists argue that more cohesive and dense elite networks gain more leverage over politics. A resulting idea of this line of research is then that one has to have an idea about how capital is organized and how relationships between business sectors and the government are structured. This literature therefore can be connected with research on forms of capitalism (hierarchical capitalism, varieties of capitalism), the welfare state and interest representation in modern capitalism. For example, taking the economic features in a country into account, one may argue that business groups are said to be more influential if the domestic economy depends more on their performance and investment flows (Fairfield, 2015; Campello, 2015), i.e. they have more infrastructural power. They will also be more influential if the domestic economy is less diversified. Some authors claim that for Latin America that business groups are more powerful as the industrial production is more concentrated around a few sectors, especially in those countries where trade liberalization has been more gradual.

6.4 Society-centered approaches

The above approaches to tax policy reform are mostly guided by rational choice interpretations of bargaining situations. Social and political actors act in their self-interest and aim to shape tax policy in a way that best serves their interests (methodological individualism). Society-centered approaches in contrast are guided by a holistic understanding of human behavior. They draw on collective phenomena to understand taxation and highlight the social embeddedness of tax bargains, such as collectively shared norms, ideas and discourses.

This literature, which draws on insights from sociology and relates the persistence of certain persistent characteristics of tax systems as a result of collectively shared norms related to taxation. For example, high levels of tax evasion and exemptions may be related to the dominance of ideas on the primacy of private property vs. the common good, or result of resistance of individuals to taxation, irrational actors' behavior (acceptance of regressive tax systems by subaltern groups) and principally long term tax policies and persistence. Studies in this literature stream study the moral justifications around heritage taxes (Beckert 2004), discursive strategies of elites towards regressive tax systems (Atria 2015), or the influence of epistemic communities on the *Zeitgeist* of tax policy design. Some authors even go as far to claim that different cultures of taxation exist in countries and blame cultural or social habits for these. Interestingly studies in this line of research borrow from psychology, particularly in methodological design. For example, they apply (natural) experiments where a group of persons participate to detect tax attitudes, stories or metaphors about taxes (Prabhakar 2008).

Common to these studies is that their aim is not always to explain specific reform experiences, but rather aim to expand our knowledge to understand in which ways general equilibria of social relations are expressed by taxation. They are more likely to expand their full potential in explaining continuity than short-term change. In contrast, research focusing on tax policy discourse is more specific to particular reform projects. For example, in analyzing the media coverage of tax policy reforms, these studies aim to detect discursive coalitions, dominant paradigms or narratives or strategies of framing of tax issues that influence public opinion.

Group work – Case Studies:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if more groups than countries, groups can select other Latin American countries). The task for each group to investigate about one recent experience of major tax reform in the country in question. Basis of the group work is either secondary literature provided by the lecturer or material gathered together by the group (newspaper, blogs, etc.). The groups should present the case in class (case description), following a process design and then develop an argument that explains the tax reform outcome. The aim of this group work is that students apply one of the theories studied to their own case studies and discuss their relevance to explain the outcome of reforms. Group works should be presented in class in a written (blog, paper, etc.) or oral form (presentation).

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Unit 7: Direct Taxation & Re-distribution in Latin America

Taxation is one of the principal government tools to redistribute income. This unit reviews the redistributive potential of tax systems in Latin America and discusses indicators and techniques for measuring the distributive impact of fiscal and tax policy. Aside from this empirical assessment, this unit connects the verifiably low distributive potential of tax systems in the region to political, economic and institutional factors that may explain this fact as discussed in the other units.

Learning goals:

- Students will become familiar with the redistributive potential of tax systems in the region.
- Students will be able to critically discuss and understand measures and indicators used to measure the distributive impact of taxation.
- Students will become familiar with tax incidence analysis and understand how such analysis is applied and can critically reflect upon this application.

7.1 Measuring the influence of taxation on equality

How do taxes influence inequality? In order to address this question consistently two concepts have to be specified. What kind of inequality is to be examined, and how should the influence of taxes be measured? Economists frequently focus on income effects of taxes and thus the question “who carries the burden of taxes?” stands at the center of tax incidence analysis. Their approach to inequality is consequently a concept based on personal or household income, less often it is based on wealth. Feminist economic scholars add that taxes do not only alter inequality in income but also between persons of different genders or races. The influence of taxes on both types of inequality is often measured by economists via incidence analysis.

The following section explains briefly the general concepts of progressive and regressive tax systems, outlines the basic rationale of incidence studies, the main indicators used in this kind of analysis and their main shortcomings. Recent estimates of the effect of tax systems on income inequality in Latin American countries are presented along with an overview of limitations of the focus on income as the main framework for understanding inequality.

7.2 Vertical and horizontal equity in tax systems

In Unit 1 we presented the idea of vertical and horizontal equity in the tax system. Vertical equity was defined as the principle that individuals with more resources should pay higher taxes than individuals with fewer resources. Horizontal equity was stated as the principle that similar individuals who make different economic choices should be treated similarly by the tax system (see also Gruber 2012). It was also mentioned that tax systems can be progressive, proportional or regressive. Economists refer here to the change of the effective average tax rate (an individual has to pay) on his income. This effective average tax rate rises with income

in progressive tax systems, falls with income in regressive tax systems and does not change in proportional tax systems.

Horizontal equity in taxes is more complicated to measure. In a general perspective one can argue that tax deductions, tax credits as well as tax subsidies are concepts which threaten horizontal equity in the tax system, as they grant taxpayers with specific characteristics (marital status, location, number of children) with preferential treatment not available to other taxpayers without these characteristics. Tax deductions allow taxpayers to reduce their taxable income by a certain amount. Tax is then assessed on the reduced income. Tax credits, in contrast, allow taxpayers to reduce the amount of tax they owe the government by a certain amount (see also Gruber 2012: 546). Although both may distort horizontal equity considerations, credits and deductions do not apply for all taxpayers with similar income and therefore their effects on vertical equity are different. In general, the literature claims that tax credits are more equitable than deductions (Gruber 2012). This is the case because the value of a deduction rises with one's tax rate and therefore one's income. As this means that deduction amounts are higher as a share of income for higher-income taxpayers, making deductions regressive. Credits on the other hand, are progressive because they are available equally to all incomes (credit amounts are lower, as a share of income, for higher-income taxpayers).

Economists frequently are interested in the total revenue loss generated by tax credits, deductions or exemption on the tax base. Therefore, they calculate the tax expenditure (for each tax). Tax expenditures are the revenue not collected attributable to tax law provisions that allow special exclusions, exemptions, or deductions from the gross taxable income, or that provide a special credit, preferential tax rate, or deferral of liability. In sum, tax expenditure is the potential tax revenue collection minus the observable collection. High tax expenditures do not only prejudice revenue collection but also lead to a tax system that is more complex and more difficult to administer.

7.3 Incidence studies to understand the effect of tax on income distribution

One major concern of economists is to understand how taxes affect markets and if they lead to distortions of pareto-optimal allocation of goods. For this it is necessary to determine who ultimately bears the burden of paying taxes (Gruber 2012). This question is principally analyzed via tax incidence analysis. Tax incidence studies are diverse and may focus, *inter alia*, on questions of optimal design of rates and tax bases, effects of taxes on markets and actor behavior, tax design, but also on equity considerations concerning taxation (see Unit 1). The following text only outlines the latter purpose, i.e. the use of incidence studies for understanding the effects of taxation on income distribution. In any case, one should keep in mind that this is a subtopic of incidence studies.

Incidence analysis has been widely used to assess the redistributive impact of taxes in Latin America in recent years. The principal reason behind the "boom" in incidence studies is, next to the persisting high income inequality in most countries in the region, the significant

improvements in survey and census data. In some countries, e.g. Mexico incidence analysis has become a mandatory reporting practice for the main income and consumption taxes published with the annual budget law.

The main idea of incidence analysis is to observe the progressive or regressive effect of taxes on individual or household income. The basic purpose behind the incidence analysis is to determine how much a person (or household) loses of its total income because of paying taxes and compare the distribution of these losses within the population with a reference distribution, for example a distribution of income or consumption per capita. Via this comparison, the degree of progressivity can be assessed. Classic measures for progressivity are (a) visually: the Lorenz and concentration curves, (b) in a summarized form the Kakwani measure (of tax progressivity) or (c) the Reynolds-Smolensky measure of redistributive capacity. Frequently, because of its wide publicity scholars also use the Gini coefficient to assess the progressivity of taxes.

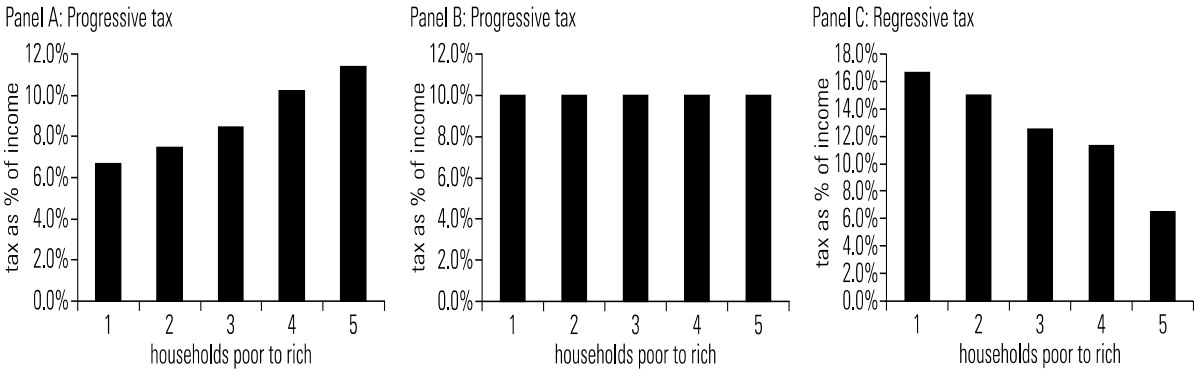
The basic logic of how to calculate the incidence of taxation is a three-step process. First, the effective incidence of each tax has to be defined. Note that the statutory incidence – who is legally responsible for paying the tax - is not sufficient because as we know from Unit 1 the tax burden can be shifted, e.g. from producers to consumers or other distortions can affect the real individual payment (tax deductions, etc.). As the effective tax rate is not known the researcher has to make assumptions who really bears the burden for each tax. These incidence assumptions are guided by theoretical considerations, empirical studies or logical reasoning. E.g. Value added tax or fuel tax is frequently considered to be shifted onto consumers, but whether this effect applies for corporate income tax is more debatable. If capital is not entirely internationally mobile a simple guideline may assume that half of the tax is born by consumers the other half by owners, and so on. Incidence assumptions can be debatable and may lead to different final results. The second step consists of computing the size of each tax. A pragmatic solution is to use the effective tax rate, but more sophisticated solutions aim to reconcile the size of each tax as estimated by applying the statutory tax rate with data obtained by national accounts. The third step is using the tax rates (and associated incidence assumptions) to calculate the burden of each tax and household. For direct taxes household income data is necessary, while for indirect taxes expenditure data is used.⁴ Only via both calculations can the incidence of the tax system be assessed. The final step is to compile measures that reveal the distribution of the tax burden among all tax payers. Typically, for this endeavor, measures of distribution are constructed. The most common are, as mentioned, the Lorenz curve, for a visual display, the Kakwani measure to assess tax progressivity, the Reynolds-Smolensky measure of redistributive capacity as well as the Gini coefficient.

The calculation of the Lorenz curve (as shown in figure 6.1) is a handsome graphical measure to highlight the progressiveness of a tax. Following the three-step process outlined above one

⁴ Note that in order to calculate the incidence of direct taxes (levied on income) information on household income broken down by source is needed. For the calculation of indirect taxes (levied on expenditure), information on household spending patterns with a substantial degree of detail is needed. Not in all countries in Latin America such data is fully available as e.g. household surveys are restricted in their degree of detail or geographical reach (only urban centers, etc.), or have other flaws.

can calculate the percentage of household income paid as tax allocating this data in means of groups, such as quintiles (five groups of the same proportion of the total linear income distribution sorted from the poorest to the richest). Figure 7.1 shows this exercise graphically for three hypothetical calculations. We can see that the distribution of the mean share of the individuals in the groups pay as taxes varies in the three figures. The distribution is progressive (poorer pay proportionally less than richer), proportional (all groups pay the same share) or regressive (the payment of poorer to richer individuals regresses as one moves up the income scale).

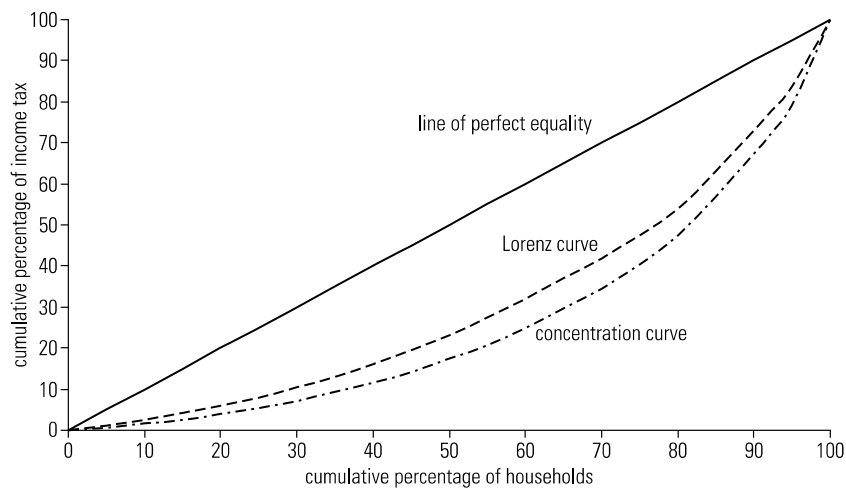
Table 7.1 Histograms for Income Tax as a Percentage of Income



Source: Own elaboration based on hypothetical data.

The problem with aggregated data (here into quintiles) is that there is a loss in information. An attractive solution is a graphical visualization of the data along two dimensions showing cumulative income per capita. The result is the Lorenz curve (bold curve) in figure 2.2. The diagonal line, in contrast, represents the line of perfect equality (increase in income per capita increases the cumulative tax payment in the same size). Finally, the figure also shows the tax concentration curve. This curve represents the cumulative percentage of tax paid on the vertical axis (for individuals still ordered progressively by income). As this curve is further away from the reference line of perfect equality than the Lorenz curve of income distribution (tax payments are more unequally distributed than income), we can say that the tax is progressive.

Figure 7.2 Lorenz and Concentration Curves for a Tax



Source: Own elaboration based on hypothetical data (panel A).

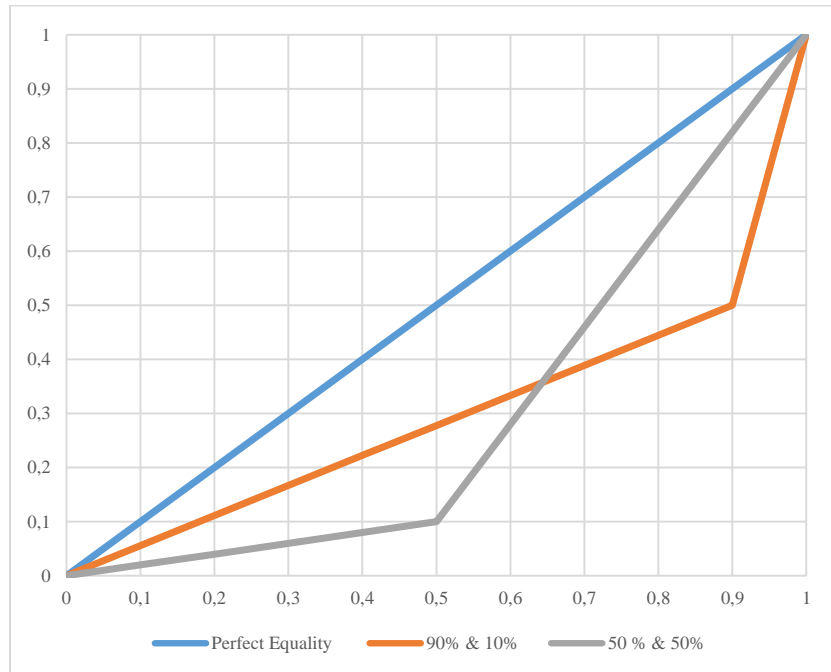
This visual exploration of tax progressivity is optically attractive as it is clear and easy to comprehend. However, a summary measure can also be useful enough that visualization is not always necessary. The Kakwani measure of tax progressivity and the Reynolds-Smolensky measure of the redistributive capacity of a tax. To compute these measures, we first have to introduce the Gini coefficient, an aggregated measure of the income distribution:

- The Gini coefficient is in mathematical terms a measure of dispersion in a population. Its use is very popular and includes other areas besides income inequality, such as banking, machine learning or natural science. Building on figure 2.2 one can calculate the Gini coefficient via the formula $A/(A+B)$; where A is the area between the Lorenz curve and the Line of Perfect Equality (see figure 2.2) and B is the area under the Lorenz curve. (Certainly, there are other approaches to calculation of the Gini without applying referring the Lorenz curve). The Gini coefficient is 1 for perfect inequality and 0 for perfect equality. Contemporary Gini coefficients in Latin America range around 0.45-0.5.

Besides its wide popularity, one of the advantages of the Gini is that it is relatively easy to comprehend and to calculate. The downside of this index is its relative high sensitivity to outliers. However, other measures of dispersion, such as the Atkinson Index exist. A more important aspect is that frequently researchers use the coefficient without proper knowledge. It is important to remember that the Gini coefficient – as any other coefficient – reduces complexity (of the distribution of income in the whole group) to a single number. If the researcher is not aware of the process of calculation, misinterpretation can occur. For instance, a Gini of 0.5 may represent (at least) two completely different distributions of income in a group. Take figure 2.3. Here two different Lorenz curves (red and blue) are pictured. Both have the same Gini coefficient of 0.4 but have a different distribution of income along the income quantiles. In the case of the red curve 50% of income is distributed among the first 90% of the population, while in the case of the blue the first 50 percent of the population concentrate only 10% of income and the other 50%,

90% of income. Thus, a researcher should be aware of the complexity reduction entailed in the calculation of the Gini coefficient if comparisons are made.

Figure 7.3 Different Lorenz curves with the same Gini coefficient



Source: Own elaboration.

- *Kakwani measure of tax progressivity*: If we have calculated the Gini coefficient for the income distribution, G_Y , we then calculate in the same way the Gini coefficient for the concentration curve (that is, $C/(C+D)$, where C is the area between the Concentration Curve and the Line of Perfect Equality, and D is the area under the Concentration Curve), C_T . The formula for computing the Kakwani measure is then:

$$K = -[G_Y - C_T].$$

The Kakwani measure is positive for a progressive tax, zero for a tax that is proportional, and negative for a regressive tax.⁵ One may determine whether the result is statistically significant by bootstrapping to estimate the standard error of the estimate of K .

- *Reynolds-Smolensky measure of the redistributive capacity of a tax*. While the Kakwani measure indicates the progressivity of a tax, it does not serve as a good guide to the impact that a change in the tax would have on income distribution or poverty. The Reynolds-Smolensky measure provides a solution to this. To compute this measure first the Gini coefficient of pre-tax income has to be calculated (as extracted from household or tax data), G_Y . Then the Gini coefficient of the post-tax income (after paying taxes, $-t$) has to be computed, G_{Y-T} . The formula is $RS2 = G_Y - G_{Y-T}$

⁵ Note that some authors define the term without the initial negative sign, so care is needed when making comparisons between one study and the next.

If RS2 is positive it indicates a progressive tax, because the after-tax distribution of income (as measured by $GY-T$) is more equal than its pretax distribution (as measured by GY). If the measure is (positive and) relatively large the tax has a higher probability to make the overall tax system more progressive (depending on its share in the total tax revenue). However, the *redistributive capacity* of a tax depends both on its progressivity and on the tax rate. It can be shown that $RS2 \approx (t/(1-t)) K$, where t is the average tax rate relative to pretax income.

7.4 Taxation and Income Distribution in Contemporary Latin America

Socio-economic inequality is one of the major challenges in Latin American societies. The focus of policies which aim to reduce these high and enduring income inequalities in the region are frequently limited to spending policies (cash transfers, pensions, etc.). However, tax policy can also be an important policy tool to achieve a more equal society (at least in fiscal terms). Compared to other regions in the world like the OECD or the European Union, the tax state in Latin America hardly contributes to a better distribution of income. Incidence studies can provide us with empirical data to support this assumption. Figure 7.4 shows the Gini coefficients for household income after the giving hand of the state (in the form of pensions or other social transfers) and after the taking hand (when income is reduced due to taxes). As observable in the EU 15 the Gini can be reduced from 0.49 to 0.3, but in Latin American countries this is not the case and income distribution after the tax state (calculated as income tax and social security contributions) hardly improves. Only state benefits, and here especially pensions have, in most countries, a more significant effect on income distribution.

Tab. 7.4 Gini Coefficients before and after taxes in Latin America

Country	Market Income (A)	Gross income only with pensions (B)	Gross Income (C)	Disposable effective income (D)
		(B= A + public pensions)	(C= B + public cahs transfers)	(D= C - PIT - SSC)
Argentina	0.536	0.49	0.484	0.469
Chile	0.546	0.526	0.51	0.499
Colombia	0.531	0.537	0.531	0.52
Ecuador	0.481	0.467	0.461	0.453
Mexico	0.496	0.494	0.484	0.46
Peru	0.487	0.485	0.482	0.461
LAC	0.5			0.47
OECD	0.47			0.3
UE-15	0.49			0.3

Source: Own elaboration with database compiled by Hanni, Martner, Podestá (2015), OECD from OECDSTAT.

On the basis of household surveys; PIT: Personal Income Tax; SSC: Social Security Contributions.

Let's see if this has to do with the design of the income tax. As stated in Unit 6, one aspect of tax reform in Latin America has been the re-design of income taxes, although structural tax reforms seldom took place. Figure 7.4 shows the different measures of progressivity explained above for six Latin American countries for the personal income tax: a) the share of gross income paid by income group, the Kakwani Index, concentration of collection among bottom 40% and top 30% and Gini index for and after the tax and the Reynold-Smolensky Indicator. For all countries, we can observe that personal income tax is progressive and that it contributes to income distribution, with Mexico as an outstanding example. However, this effect is low, basically because the weight of the personal income tax in the tax system is still limited.

There are different explanations for the Latin American allergy to the personal income tax. Arguments against heavy progressive taxation can be found in economic theory and contemporary national as well as international discourses in which parties, governments, pressure groups or international organizations participate. Explanations of the pattern of the low contribution of the tax state to income distribution in Latin America can be historical (see Unit 2), related to the political economy of reform (see Unit 6), the predominance of structural economic factors such as the importance of revenues from natural resources (see Unit 10), problems of federal coordination (see Unit 11), the capacity of the state to extract revenues and its weak legitimization (see Unit 3), the dominant social configuration in a society (Unit 3), or the predominant perspectives on equality, justice and fairness (Unit 5). Explanations of the low distributive impact of Latin American tax systems, a decisive characteristic of Latin American tax systems compared to their European counterparts, thus seems to refer to various aspects and different perspectives.

Figure 7.4: Progressivity Indicators and re-distribution of the personal income tax, 6 Latin American countries (2011)

Country	progression of mean rates											Kakwani Index	Concentration of collection		Gini before -tax	Gini post-PIT	Reynolds-Smolensky Index
	<i>(in % of gross income)</i>												40% inferior	20% superior			
	D1	D2	D3	D4	D5	D6	D7	D8	D9	D10	Total						
Argentina	0	0	0	0	0,1	0,1	0,4	0,9	2,5	9,1	3,9	0,42	0	96,1	0,484	0,467	0,017
Chile	0	0	0	0	0	0,1	0,1	0,3	0,9	7,1	3,2	0,44	0	98,5	0,51	0,495	0,014
Colombia	0,2	0,2	0,2	0,2	0,3	0,3	0,4	0,5	0,8	4,4	2,1	0,37	1	93,1	0,531	0,523	0,008
Ecuador	0	0	0	0	0	0	0	0	0	2,5	0,9	0,52	0	99,9	0,461	0,457	0,005
Mexico	-2,1	-1,9	-1,4	-0,9	-0,2	0,6	1,4	2,6	4,7	10,6	5	0,44	-3,6	94,7	0,484	0,461	0,023
Peru	0	0	0	0	0,1	0,2	0,4	0,8	1,5	5,8	2,5	0,41	0,1	93,7	0,482	0,472	0,01

Source: Own elaboration with data from Hanni, Martner, Podestá (2015); calculated with household survey data.

Group work – Case Studies:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if there are more groups than countries, then groups can select other Latin American countries). The task for each group is to research the characteristics of the direct taxation in the country in question. Each group should present contemporary and historical data on direct taxation in the country (indication of data sources is given by the lecturer), provide a summary of types and characteristics of direct taxes and present the overall re-distributive impact of taxation in the country (based on desk research). At best, each group should present some hypothesis on why the low re-distributive impact in the country exist and persist.

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Unit 8: The Transnational Dimension of Taxation

Globalization increasingly shapes the lives and realities of people all around the world. In social science, this reality is increasingly visible as the nation state, far too long the principal reference point and “container” in which social and political processes were studied, is losing importance for the sake of transnational flows, movements or processes. With respect to taxation, the transnational dimension remains remarkably underexplored. This is not to say that there is no awareness that globalization and transnational processes such as transnational mobile capital are of imminent importance for taxation, however research from a social science perspective is still in its footsteps.

Nevertheless, there are several issues which have been treated in the literature and which will be treated in this Unit: the effect of economic globalization on tax systems, global and domestic tax competition, challenges of taxation of mobile vs. fixed capital in times of globalization (tax shifting, transfer pricing, tax avoidance). In addition, attention is given to the question of global tax governance, visible today in multilateral efforts to impose regulation in international tax matters (BEPS initiative, ICRICT, etc.).

Learning goals:

- Students will become familiar with current challenges to cross-border taxation and their relevance for Latin America.
- Students will understand perspectives on tax competition and their possible effect on domestic tax systems.
- Students will become aware of the influence of transnational actors and institutions on Latin American tax regimes and the challenges this influence entails.
- Students will be able to argue if global tax governance is probable and which challenges exist.

How did globalization affect tax systems? In order to find an answer one first has to define what is meant by globalization. As there is no consensus in the literature, different effects are observed and conclusions drawn. Studies conceptualize globalization differently, they are concerned with increased global capital mobility, free trade (and its regulations), movements of economic actors or increased illicit or licit financial flows. Second, the literature differs in what changes within tax systems have been observed. Here the literature focuses on aggregated indicators like tax level or structure, specific taxes and their characteristics, or the reactions of tax agencies or governments to increased globalization.

8.1 Economic globalization and tax systems, global and domestic tax competition

One of the basic features of globalization is increased capital mobility. Since the abolition of fixed exchange rates within the Bretton Woods System, the importance and mobility of international capital has steadily increased and has been identified as one of the most salient parts of the “increasing” globalization, in the sense of global economic interconnectedness

(Cox 1996; Robinson 2004). As this characteristic was observed in the 1990s, investigators explored if the increase in international capital mobility introduces changes in domestic politics, especially in welfare and tax policies. In this time, several hypotheses were put forward:

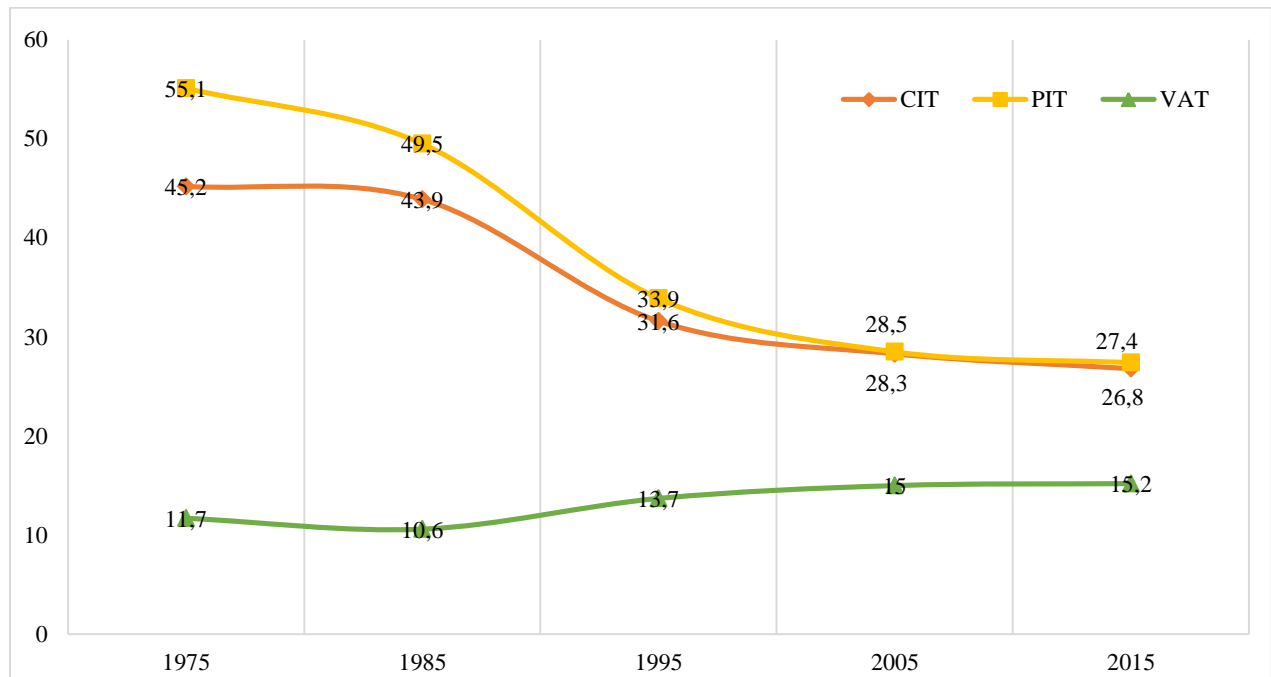
- (a) A “compensation hypothesis”, i.e. that an increase in international capital mobility in a country will either have no effect or even increase forms of social protection (Swank 2002, 32). This expectation is based on the experience of industrialized countries, because governments were assumed to “protect” their citizens from the perils of globalization.
- (b) A “curvilinear hypothesis, which assumes that such a compensation may be possible in the short-term perspective, but in the long run, under high levels of asset mobility, international financial openness will undercut the ability of governments to finance social welfare mechanisms (Hicks 1999; Rodrik 1997), due to the reduction in tax levels and the global competition for cheap labor (costs).
- (c) A “negative hypothesis” which argues that a reduction in tax burdens on corporate profits and high income-earners will follow in the wake of increased capital mobility (Steinmo 1993, 1994) and thus in a reduction in welfare spending.
- (d) Hypotheses which are driven by changes in the behavior of (government) actors. Such changes are said to be caused directly and indirectly. Direct effects are, e.g. in the sense that governments take the potential effect of international capital to economic growth explicitly into account when designing policies, thus adapting their policies via “anticipatory obedience” to globalization. Indirectly because international capital mobility (and its importance) may strengthen domestic social and political forces, for example business groups or organizations, that advocate for a neoliberal economic agenda (Swank 2002: 21) and thus a reduction in tax levels or a shift towards indirect taxation. In contemporary times, such a perspective is complemented by research which observes dynamics of elite networks and trans-nationalization.

After more than two decades we have a clearer picture of the general tendencies of the effects of globalization on tax systems, however most of the concrete mechanisms through which this process functions in detail is still unclear:

- There is consistent evidence that, at least in industrialized countries, large welfare states have survived globalization, under the condition that these countries were able to develop a tax system with a significant base in (indirect) consumption taxes (Hays 2003). That is globalization has led to a change in the tax structure in industrialized countries. Income taxes, especially on corporate income have decreased consistently since the 1970s, while indirect taxes, especially taxes on consumption (VAT, etc.) have filled this revenue gap. Nevertheless, there is constant pressure that labor costs are too high and most industrialized production now moved to Asian countries or was replaced by of automatization or digitalization of industrial production.
- In Latin America one can observe two long term trends. First, trade taxes have been the backbone of Latin American tax systems (see Unit 2) for a long time, but beginning in the mid 1980s with the rise of policies of economic liberalization they were significantly

reduced or dismantled. Trade taxes now play, if at all, are marginal role for state financing. In addition, following their peers in the OECD world, much of Latin American countries now reformed tax income laws allowing for taxation of capital income, although frequently at a lower rate.

Figure 8.1 Marginal maximum tax rates in Latin America*, 1975-2014 in %



Source: Own elaboration based on Morán and Pecho 2017. *simple average of countries for years selected; CIT = Corporate Income Tax; PIT = Personal Income Tax; VAT = Value Added Tax

- Secondly, top marginal tax rates, especially in the (corporate and personal) income tax are falling since the beginning of the 1970s, following a pattern that is observable in much of the industrialized countries. Average marginal maximum rate of PIT fell from 55.1 in 1975 to 27.4 in 2015 and marginal maximum rates fell of CIT fell from 45.2 in 1975 to 26.8 in 2015 (see figure 8.1). In addition, several Latin American countries have made intensive use of tax exemptions to attract foreign capital investment. As Table 8.1 shows tax incentives in different forms are much more frequent in the LAC region than in the OECD world, but similar to Asian countries. Worse, however, is that tax incentives are made in areas which are not bound to clear conditions, e.g. investment in research and development (R&D) but are made temporarily (tax holidays). However, incentives such as tax holidays are seen by many observers as the least effective measure to attract foreign direct investment or spur growth (Klemm 2010).

Table 8.1 Prevalence of tax expenditure in Latin America, OECD and East Asia and Pacific region, share of total countries in region (2014)

Region	Tax holiday/ Tax exemption	Reduced tax rate	Investment allowance/Tax credit	R&D Tax Incentive	SEZ/Free Zones/EPZ/Freeport	Discretionary Process
East Asia & Pacific	92%	75%	67%	83%	92%	83%
LAC	88%	32%	52%	12%	72%	40%
OECD	21%	36%	64%	76%	67%	33%

Source: Own elaboration with data from James (2014): <https://tinyurl.com/ybrngvz>; LAC 25 countries, OECD 33 countries, EA&P 12 countries.

- Some Latin American countries, most notably Panama or some Caribbean countries opted to base their economic development models on low to zero income taxes for foreign capital, effectively functioning as tax havens for capital owned by corporations or individuals from countries of industrialized but also of non-industrialized and Latin American origin. With recent data leaks and growing global tax cooperation, these strategies of economic development are increasingly questioned.
- Despite this trend of adaption of tax systems to the global competition for capital investment in some Latin American countries, important heterodox tax policies have been implemented in crucial moments. This was the case for Argentine export tax after the default in 2001/2, taxes on bank debits and temporary taxes on wealth in Colombia, or the renegotiation of tax regimes for the extractive sector during the commodity boom (see Unit 10). In sum, although in many areas of taxation economic globalization and global competition have shaped tax regimes in the continent, in the long run important domestic factors keep influencing tax policy and may explain differing paths of tax systems (see Unit 2 and 6).

8.2 Transnational companies and global tax compliance

Critics of liberal economic globalization hold that transnational enterprises are the principal beneficiaries of the contemporary global trade regime. In particular, transnational capital is said to be able to exploit differences in tax regimes around the world and global tax competition to reduce their tax dues and/or not comply with their tax liabilities. Measurement of such behavior is difficult and complex. However, contemporary studies suggest that such illicit financial flows are particularly damaging for non-industrialized countries. For example, some authors assert that the money drain caused by illicit financial flows is far greater than development aid by other countries and international organizations combined (Reuter 2012). With respect to corporate global tax non-compliance – one important part of illicit global capital flows - strategies of global tax behavior of multinational or transnational corporations have received attention in the literature:

- *Profit shifting.* Estimates suggest that revenue losses suffered by non-industrialized countries due to corporate profit shifting range between approximately US-\$ 35 billion and US-\$ 160 billion per year worldwide (Fuest and Riedel 2010). Profit shifting describes activities by corporations to move profits from a country where the activity occurs to territories where profits are taxed at lower rates and expenses to where they are deductible at higher rates. This is possible because companies generally have to pursue separate accounting systems in the countries they conduct their activities and thus can move profits and expenses between different national accounting systems. However, it could be argued that large corporations also use some company items, services, etc. in several countries simultaneously and therefore a clear national split between the activities of one corporation in several countries cannot be made.

Profit shifting largely happens within one firm and may be part of wider corporate tax planning strategies. These strategies can be technically legal and take advantage of the variety of tax rules and principles in multiple countries. Some of these strategies can also violate the law. The overall effect of this behavior is the erosion of the corporate tax base in many countries, whether industrialized or non-industrialized. The exact magnitude of this corporate behavior has not yet been identified properly due to challenges to measurement and calculations.

- *Transfer pricing.* While profit shifting largely operates within firms, transfer pricing functions between firms, or at least legally independent entities of one corporation. For example, multinational firms set transfer prices for intrafirm trade in order to separate profits generated in different countries. This can include the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between truly independent entities. This also applies to the location of intangible assets like e.g. patents in low tax countries or the use of intrafirm debt and other financial instruments to shift income from one country to another. While some of this is legal, practices which involve severe mispricing or faked transactions in order to reduce tax payments have to be classified as tax evasion.
- *Tax havens.* The existence of tax havens is widely criticized. In these territories, low tax rates are often combined with fiscal secrecy. Recent publications show that tax havens are widely used by wealthy individuals all around the world (but especially of non-industrialized countries). Tax havens are often associated with tax evasion and can also be useful for organizations or individuals operating in illegality. Given that several Caribbean islands and countries fall in this category, tax havens should also be a Latin American concern. With respect to the discussion around tax havens several topics such as tax evasion, fiscal and banking transparency as well as global cooperation in tax matters interrelate.

8.3 Global governance of taxation – from competition to cooperation?

Countries not only compete in tax matters, they also cooperate. Perhaps the oldest form of tax cooperation is the bilateral tax agreement between two countries to avoid double taxation. Of more scholarly interest are forms of multinational cooperation in tax matters with the aim of reducing tax evasion. The literature on global tax governance uses insights from studies of cooperation in international relations (IR) in other areas (security, environment, etc.). As there is no global authority with rule-making and especially rule enforcing powers, states find themselves in a dilemma either to pursue short term gains or to cooperate with the hope that their peers will do the same and do not engage in free-riding. Cooperation thus hinges on interest calculation, multilateral negotiation and coordination. Maybe the only specificity in tax matters is that some authors argue that taxation is a particular sensitive policy area, as it is seen as one of the cores of state sovereignty.

Nevertheless, institutions of global tax governance are emerging. Take for example the BEPS initiative put forward by the OECD or international agreements to share tax and fiscal data between countries. This shows that countries can overcome the collective action problem, give up part of their sovereignty and engage in necessary global policy initiatives. Scholars interested in these processes now try to understand:

- (a) When cooperation is possible;
- (b) What kind of cooperation occurs (e.g. which institutional setting emerges?);
- (c) What kind of topics are subject to cooperation and why they are selected, and
- (d) How the globally set norms feed back in domestic policies or in other policy areas linked to taxation.

Group work – Case Studies

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if there are more groups than countries, groups can select other Latin American countries). The task for each group is to present: a) data on the magnitude of transnational tax evasion and avoidance, b) the countries position to global tax governance initiatives c) present a resume of the impact of the Panama Papers in the country in question. With this information in hand they should prepare a short brief of the importance of the transnational dimension of taxation in the country in question. The group should present the ‘report’ before the class and show possible solutions.

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Unit 9: Tax Compliance, Avoidance and Evasion

Tax avoidance and evasion are serious challenges to taxation in Latin America. Thanks to the contemporary very high levels of evasion and avoidance in the region, Latin American countries fall short of collecting the full potential of established taxes and thus lose necessary fiscal resources. Besides the negative effects on tax collection, avoidance and evasion also have wider impacts. They pose an imminent threat to the vertical and horizontal equality of tax systems (see Unit 1) and threaten the cohesion of societies in general. Without tax non-compliance, tax administration would be able to collect an equal amount of revenue of a tax but with lower tax rates (horizontal equality) and, as tax evasion is especially severe in taxes on personal income and in upper income groups, tax non-compliance impedes a more just society (vertical inequality). In addition, avoidance and evasion can seriously undermine the legitimacy of tax systems and foster increasing levels of non-compliance and delegitimization in general. Low tax morals – as some authors describe the persistent patterns of non-compliance by taxpayers – may therefore be coupled with citizen's perceptions of the state, public services or corruption, i.e. low tax morals can be seen as a proxy for a broken fiscal contract.

How can we explain persistent levels of non-compliance by taxpayers even if the quality and quantity of public services increases? Soon we see that explaining high levels of tax evasion and avoidance is challenging. This unit provides an overview of the most salient approaches to explain tax evasion and avoidance in Latin America, including technical (tax design), economic, political, society-centered as well as individual centered arguments. But before these approaches are exposed, the unit engages in conceptual clarification by discussing how evasion and avoidance can be measured and a short overview over actual patterns of evasion and avoidance in Latin America.

Learning goals:

- Students will become familiar with concepts of tax evasion, avoidance and compliance.
- Students will become aware of the challenges to measure tax evasion and avoidance and have an overview of levels of evasion and avoidance in the main taxes in Latin American countries.
- Students will learn and be able to apply different approaches to understand and explain tax evasion and levels of compliance in Latin America.

9.1 Tax evasion and avoidance in Latin America – Measurement and Evidence

Tax evasion and avoidance are two different concepts describing the non-compliance of a taxpayer (physical or juridical person) with its tax obligation, i.e. tax non-compliance (*incumplimiento tributario*). Most frequently tax non-compliance which is accomplished via illegal means, violating the law, is called tax evasion. Tax avoidance, in contrast, is frequently defined as tax non-compliance pursued within the law, for example using legal loopholes (tax credits, tax exemptions), taking advantage of irregularities in the tax code or, in the case of

corporations, engaging in strategies of aggressive tax planning with the help of law firms and taking advantage of aspects related to the transnational dimension of taxation (see Unit 8). In practice drawing the line between tax evasion and avoidance is often difficult as the boundaries between both concepts are fluid. While non-declaration or underreporting of income as observed in the informal sector may be identified easily as tax evasion, the practice of transnational companies using strategies of transfer pricing or profit shifting are often pursued in a grey zone between avoidance and evasion, including both concepts.

How can tax evasion be measured? Several approaches to estimation exist but two general categories can be distinguished, according to the data sources the methods use (Jorratt and Podestá 2010). The first group comprises estimation techniques related to measures of the global economic system, systems of macro-economic behavior or indirect approaches. These calculations make use of economic aggregates such as national accounts, take advantage of household surveys or relate tax collection to the use of physical inputs used in the production of goods and services. The second group joins approaches related to partial systems of the economy, micro measurements or direct approaches. Estimations in this group infer, based on a sample considered as representative, the behavior of a determined group of tax payers. The data used in such estimations is taken from special auditing programs or other samples of tax data or behavior. In any case, caution has to be taken with the accuracy of all calculated measures. All tax evasion measures aim to quantify a phenomenon, the principal characteristic of which is that it is hidden from measurement and statistics (otherwise presumably if a tax administration would know about non-compliance, they would also enforce payment) and thus should be regarded as approximations with room for error.

Among the most common approaches to quantify tax non-compliance is the method that draws on information from economic aggregates. Such calculations also known as *macro accounting methods*, draws on the underlying idea that the tax gap which can be identified via the discrepancies between the national and financial accounts of a country can be explained by tax non-compliance.

One application of such a method is estimating the potential collection of a tax from the national accounts data and to later compare this potential collection with actual or effective collection, obtaining a gap that is usually attributed to tax evasion. This approach is most useful for quantifying evasion for a flat rate tax with a tax base which is related to some macroeconomic aggregate. This is why it is mostly used for estimating evasion in VAT and corporate income tax (CIT). The main advantages of this method are that it is relatively easy and inexpensive to calculate and that it allows measuring evasion for a time series (annual data) which can show the evolution over a given period. The most mentioned limitations are the reliability of the sources used for calculation and, particularly in the case of the VAT, that it requires a theoretical definition of assumptions on how to calculate the potential revenue ex-post.

In the case of VAT, the method of tax potential of the economy requires calculating a theoretical collection of the tax - which must then be compared with the tax actually collected

- for which there are two alternatives: a) the method of production, which consists in estimating - with sectoral data from the national accounts - the sales and purchases with right to a tax credit, which determine the debit and the tax credit, from which the net VAT of the entire economy is generated; or b) the method of consumption or “non-deductible VAT”, which seeks to calculate the total amount of transactions that generate VAT and that subsequently do not have right to tax credit within the value added chain, i.e. those corresponding to final consumption of goods and services taxed and the purchase of taxed goods and services that are used in the manufacture of exempt products. This second variant, because it is more independent of the level of disaggregation of the information used as input, is the most widespread among the studies carried out in the countries of the region.

With regard to corporate income tax, the methodology usually used estimates the theoretical tax revenue from the surplus of national accounts, which is the macroeconomic aggregate that is closest to the concept of taxable profit (*utilidad tributaria*). This aggregate is then subject to a series of adjustments to gain the potential tax base, for example by adding interest and land rents, deducting the operating surplus from exempt and non-affected sectors and activities, adding the differences between tax depreciation and financial depreciation, among other corrections. The application of the statutory tax rate on this theoretical tax basis gives the theoretical collection, which, compared with actual tax collection, allows tax evasion to be determined.

For the calculation of evasion in the ISR (*impuestos sobre la renta*) of natural persons, the most used methodologies are those that are based on the estimation of the potential collection with data from household surveys. Due to the progressive nature of these taxes, the use of these data bases which allow different rates to be applied in different groups is most appropriate. The method consists of calculating the tax that each individual should pay, depending on the income of the individual - corrected and adjusted by non-response and underreporting of income - if the corresponding scale of tax rates were applied. Subsequently, the calculated collection is grouped in the different percentiles of income and is compared with the effective collection obtained by the tax administration for each similar fraction of the population. The main advantages of this method are its simplicity and low cost while a limitation is expected to be a frequently high level of omission and underreporting by respondents.

Other methods in the indirect approaches are the money demand approach and the physical input approach. Both try to estimate the overall size of the shadow economy which is assumed to be the main driver behind tax evasion. The physical input method uses proxies, such as the electricity demand, to measure (overall) economic activity in a country. Compared to economic activity in the official GDP data, the unofficial GDP is identified and the subsequent loss in tax revenue can be calculated (see e.g. Kauffmann and Kalibera 1996). The money or currency demand method, by contrast, aims to estimate the extent of the shadow economy based on the idea that many activities in this area involve cash payments to avoid to be traced. Via econometric models, such studies estimate the influence of certain indicators

on the “excess” demand of currency and can also provide estimates for the size of the shadow economy. However, both methods have their disadvantages.

Other, more direct, methods – which fall in the second group of micro approaches mentioned before – are fixed-point sampling methods. These methods use data from audits of a sample of taxpayers from which precise information on the evasion rates can be obtained and then inferred for a wider population via statistical methods. Although these calculations have the main advantage that various types of statistical techniques can be applied, their effectiveness depends, among other factors, on the experience of those who carry out such audits. In addition, the extrapolation of the results to the rest of the population is very complex due to the implicit bias caused by the tendency to focus audits only on those tax payers who are more likely to evade taxes. In non-industrialized countries such micro level data is frequently not available at the required level of quality.

However, if information is based on randomly selected taxpayers the estimates of tax gaps are said to be more reliable and informative than results of macro approaches. If micro data of sufficient quality is available, this not only allows estimation of tax gaps more accurately but also more detailed information on characteristics and sources of tax evasion (which income is subject to evasion, which groups are more likely to evade and what are their characteristics). In Latin American tax administrations, have pursued such studies but this information is frequently not made public.

9.2 How severe is tax evasion in Latin America?

One of the good news in Latin America is that society and public authorities have become increasingly aware of the importance of the problems of tax evasion and avoidance. In this sense, most of the countries in the region are following a general trend around the world, which has gained additional momentum with the publication of large data leaks such as the Panama Papers in 2016. Nevertheless, other than in the EU countries where a common methodology and periodical estimates are published, no country in the region officially measures tax evasion periodically for all tax items. This seriously undermines the efforts to understand tax evasion and other phenomena related to evasion, to set milestones or establish an empirically based plan to fight tax evasion as well as it impedes to assess the efficiency and effectivity of tax authorities in Latin American countries. In the few countries in which tax evasion is measured this practice is largely restrained to the measurement of evasion in the VAT. Evasion in other large taxes is measured only in a few countries such as Mexico.

In Chile, the Servicio de Impuestos Internos (SII) measures evasion in VAT annually and has established ambitious measures to reduce noncompliance. In Colombia, the Dirección de Impuestos y Aduanas Nacionales (DIAN) and in Uruguay in charge of the Dirección General Impositiva (DGI) have made an effort to elaborate, actualize and, most importantly, publish a series of quantitative studies by which it is possible to observe the level of evasion over the last ten years. Mexico is a particular positive case where the Servicio de Administración Tributaria (SAT) has for some time the legal obligation to publish studies on tax evasion

annually in which at least two national academic institutions have to take part. The result is a diverse set of studies with a global perspective or a focus on specific aspects and dimensions of evasion in some core taxes, VAT and income tax which enable them to gain a more complete picture of the trends and current reality of tax noncompliance in the country.

Table 9.1 includes the results of some of these studies and adds results from other studies as summarized by Gómez Sabaini and Morán (2016) for estimates of tax evasion in the VAT for the period 2000 to 2014. The numbers indicate the share of potential revenue collection lost by noncompliance of tax payers. All of the listed countries present measures that decrease over time and suggest that evasion in VAT has decreased and the work of tax authorities to better tackle the problem of noncompliance has turned out to be effective. Still these numbers are quite high, especially in comparison with data on tax evasion in the EU countries. One should also remember that the VAT is generally viewed in the literature as a tax that is relatively easy to collect, as the tax burden passes through several economic agents, which reduces incentives for evasion and increases the ability for successful control by revenue authorities. In most Latin American countries (Argentina, Costa Rica, Colombia, Ecuador, El Salvador, Mexico, Uruguay) more than 20% of possible VAT income is evaded. In countries like Guatemala, Nicaragua, Panama, Peru, and Bolivia, the evasion rate is even as high as 30% or more (Gómez Sabaíni et. al 2012). More recent data for Chile, Uruguay, and Mexico in 2014 show a decline in the rates in each country but still show a tax evasion rate under 15% only in the case of Uruguay.

Figure 9.1: Estimates of tax evasion in value added tax, % of potential revenue (2000-2014)

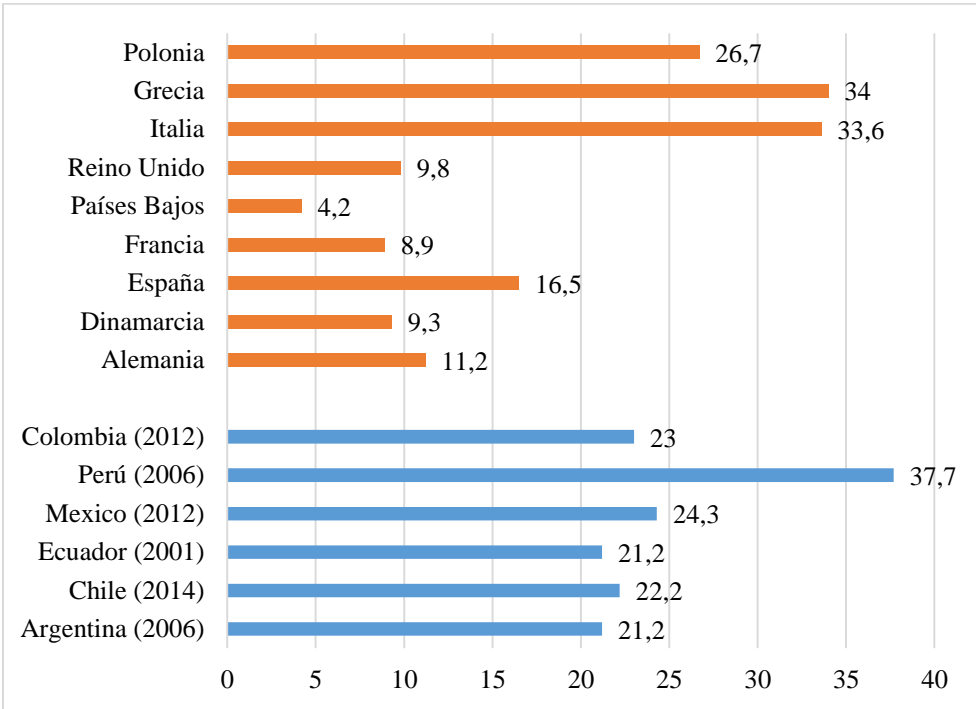
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Argentina		29.6	34.8	32.3	24.8	23.3	21.2	19.8							
Chile				18	18.1	16.7	15.9	14.8	22.5	29.2	22.2	23.6	24.8	24.3	22.2
Ecuador		21.2													
Mexico					34.9	31.7	25.5	27	24.3	26.3	27	29.5	24.3		
Peru		49.5	48	45.9	44.2	42.9	39.4	38.4	37						
Colombia	37.9	36.6	37.5	34.9	31.8	30.2	27.7	24.8	23.7	26.1	24.9	22.6	23		
El Salvador	42.4	39.2	38.8	37.4	39.1	35.4	30.4	34.2	36.3	39.2	33.1				
Uruguay	39.9	37.4	40.1	36.1	30.8	30.1	27.8	22.7	20.2	17.2	14.4	14	13.4		

Source: Own elaboration with data from Gómez Sabaini, Morán (2016)

In addition, although with a positive trend, revenue gaps in the six countries are still far from as low as the ones found in industrialized countries in Europe, with the exception of the countries of Eastern Europe and two European cases with historically very high rates of evasion, Greece and Italy. Table 6 shows the calculation of evasion in VAT for European countries with a standard and comparable methodology. The countries with a larger informal sector or economies suffering a prolonged recession since 2008 - Poland, Greece and Italy - have higher evasion rates. The rates of the six Latin American countries, although calculated

with more unreliable data and a different methodology, are lower than in these countries in Europe, indicating a positive result in anti-evasion efforts of tax agencies. But in comparison with the countries of the European economic nucleus, rates are twice as high. However, given the economic volatility in Latin America and the large informal sectors - two very negative factors for better compliance with VAT - it is questionable if the positive trend in the reduction of evasion can be prolonged.

Figure 9.2 Rates of tax evasion in VAT for 6 Latin American & selected European countries (year 2013), in %

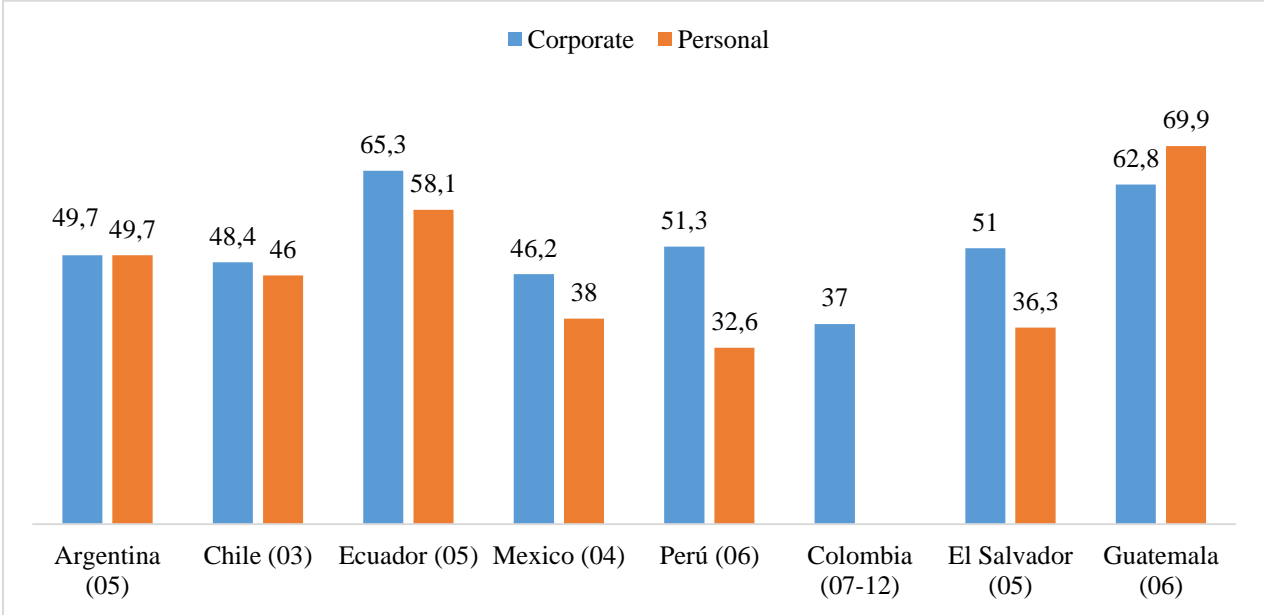


Source: Own elaboration with data from Gómez Sabaini, Jiménez and Podestá (2010)

Despite the achievements in combating tax evasion in indirect taxes such as the VAT, tax non-compliance in direct taxes such as the income tax remains broad and a real challenge for countries in Latin America. Figure 9.3 shows that the selected Latin American countries lose between one-third and more than half of potential income tax revenue. Interestingly, almost always the rate of tax non-compliance in corporate income tax is higher than in the case of personal income tax. This may have several reasons. One is that there may be greater incentives for evasion (informality, existential advantages) but also greater professionalism in practices of evasion and illusion via the help of intermediaries (audit companies or law firms) using strategies of aggressive tax planning to lighten the corporate tax burden. In addition, the cases of transnational companies' strategies of transfer pricing and profit shifting are also a major concern (see Unit 8). Still, evasion of the main progressive tax, the income tax on individuals is also very high and lowers its contribution to reduce income inequality and restore tax fairness. In addition, for many scholars, the high levels of tax non-compliance are a sign of a broken fiscal contract. Via evasion, taxpayers express their discontent and their

rejection of civic responsibility of individual contribution to the public good (see Unit 4 and 5).

Figure 9.3 Estimates of tax evasion of corporate and personal income tax in selected Latin American countries, % of potential collection (various years)



Source: Own elaboration with data from Gómez Sabaini, Jiménez and Podestá, A. (2010); Colombia: DIAN

9.3 Tax expenditures and tax non-compliance

Another salient feature of Latin American tax systems are multiple exemptions, exclusions, deferrals, allowances, deductions, reduced tax rates and special regimes that persist in all countries in the region. All of these concepts can be summarized in the concept of tax expenditure. The idea behind this term is that all of these exceptions comprise a kind of public expenditure. However, this expenditure is not clearly integrated in the public budget and thus frequently escapes congressional debates on the annual budget. Nevertheless, it can be perceived as expenditure as it is a government decision to deny – out of certain reasons - the collection of certain types of taxes.

Tax expenditure can have a geographical limitation (free-trade zones), a temporal limit (tax holiday) among others. Arguments in favor of tax expenditure are diverse but often render their assumed positive effect on: attracting or increasing (foreign direct) investment, stimulating savings, developing financial markets, developing backward regions, export promotion, industrialization, employment generation, environmental care, technology transfer, diversification of the economic structure, human capital formation, etc.. However, there are several studies that could show that there is no necessary causal relationship between the expected goals and tax expenditures in every case, for various reasons. More importantly tax expenditures should be seen critically for several reasons:

- they weaken the tax base and create revenue losses;
- tax expenditures threaten horizontal tax equity;
- they pose a threat to fiscal transparency and political accountability;
- they make tax legislation more complex, increase the costs of tax collection and complicate the auditing of tax payers by tax agencies;
- as a form of expenditure they are less visible in the budgetary process and debate;
- as legislative and public control of them is more difficult, they are frequently more vulnerable to the capture of lobbying, business groups or special interests or even corruption;
- as they increase the complexity of the tax system and increase the cost of effective control and tax system management they can favor tax non-compliance.

In Latin America numerous studies show that the risks of tax expenditure should be taken seriously and frequently out rule the expected gains. Most importantly these are expenditures that, given the low levels of tax collection in many countries, the states cannot afford.

The measurement of tax expenditures is still much debated in Latin America. A common way to measure tax expenditure is to compare the actual tax collection (of a tax) with a previously established benchmark of expected collection. However, how this benchmark is set is subject to major debates and can vary substantially. This is the main reason why no common standard of calculation is shared among countries, and researchers should be cautious when comparing estimates based on different methods of calculations among countries, as estimates are not necessarily comparable.

Table 9.1: Estimations of tax expenditure in selected Latin American countries

Tax	ARG	CHI	COL	ECU	MEX	PER	average
VAT	1.17	0.83	2.51	2.4	1.53	1.32	1.63
Income Tax	0.56	3.62	0.9	3.11	2.23	0.37	1.80
<i>PIT (Personal Income Tax)</i>	...	2.77	0.3	0.71	0.84	0.15	0.95
<i>CIT (Corporate Income Tax)</i>	...	0.85	0.6	2.4	1.39	0.22	1.09
Social Security	0.33	...	...	...	...	...	0.33
Selective/Special taxes	0.31	...	...	...	1.15	0.07	0.51
Trade	0.12	...	...	...	...	0.17	0.15
Others	0.03	...	...	...	0.08	...	0.06
Total (% of GDP)	2.5	4.5	3.4	5.5	5	1.9	3.80
Total (% of tax collection)	6.8	21.4	17.4	27.2	25.5	10.7	18.17

Source: own elaboration with data from Gómez Sabaini y Morán (2016)

With this restriction to cross-country comparisons in mind, Table 9.1 shows that the magnitude of tax expenditures is highly relevant in the presented six Latin American countries. Between 2 and 5.5 points of GDP or between 7 and 27% of the total tax pressure is

lost to the state for these exceptions. On average, of the 6 countries represented in Table 4, this means a loss of collection of 3.8 points of GDP, which represents more than 18% of the existing collection. Countries such as Chile, Ecuador, and Mexico collect more than 4 GDP points less, equivalent to more than 20% of their annual tax revenues. Tax expenditures are more relevant for important taxes such as VAT and income tax. For both, on average for the total of the 6 countries their magnitude is similar in both categories. However, there are special cases like Chile and Ecuador that lose more than 3 points of GDP in tax expenses for the income tax.

9.4 Explaining tax evasion and avoidance in Latin America

It is common wisdom that nobody likes to pay taxes. However, this common wisdom alone does not necessarily explain evasion or avoidance of taxes. So, what can explain tax non-compliance? In general, there is no straight forward answer and in fact tax revenue losses due to tax non-compliance can occur out of a number of reasons. First, the reasons may be related to the type of evasion we are talking about. One principal difference should separate tax non-compliance which is related to domestic dynamics and the transnational component of tax non-compliance which is much more related to transnational dimension of taxation discussed in Unit 8. In the literature, discussion of these two different kinds of phenomena are frequently separated. The transnational forms of non-compliance are closely related to the topics in Unit 8 and forms of global governance of taxation. Literature on the domestic aspect of evasion has a longer tradition and is closely related to structural aspects of the economy, tax design, behavioral aspects of tax payers, but also to administrative capacities and societal dynamics. All of these aspects will be presented briefly in the following section.

Contextual and structural economic factors

- 1) In the literature, there are few doubts that tax evasion is connected with the size of the “shadow economy”. In fact, as we have seen revising the methods used to calculate tax non-compliance, the size of the shadow economy has been used as a proxy to infer to the quantity of tax payments evaded. Definitions of what is the shadow economy vary. Some authors claim that it is all “unreported income from the production of legal goods and services, either from monetary or barter transactions, hence all economic activities that would generally be taxable, [if they] were they reported to the tax authorities” (Schneider and Enste 2000: 78-79). This definition is very close to what we have defined as tax evasion.

In Latin America, many economists also speak of informality or the informal sector instead of the shadow economy. Their claim is that a large informal sector, i.e. business which are not registered or whose employees do not possess a legal labor contract, has a negative impact on tax evasion. This is because the comparative advantage of most firms or persons operating in informality is based on evading or not paying taxes and social security fees. Either because of the business operating in illegality or linked to criminal activities, or because the only way small companies can compete against dominant

corporations in the domestic market (which can reduce costs due to the economies of scale) is via evading taxes. In addition, these companies also face structural challenges as they lack the capacities to comply with their tax debts or are unable to administer the company's fiscal accounts properly.

Nevertheless, one should be cautious with the assumption that all economic activity operating in informality or the shadow economy can be taxed. This is because a large informal sector or a sizable shadow economy is a result of a deliberate policy choice (e.g. informal care work, etc.) and thus a reduction would neither increase revenues nor benefit the welfare state. In addition, informality as well as measures of the shadow economy include illegal activities in which, even if they could be stopped, no tax revenues would arise. In any case, there is solid evidence to believe that a large informal sector directly and indirectly poses a major challenge to tax collection. Directly because taxes are evaded but also indirectly as it negatively impacts collective tax morals and delegitimizes the state (see section above).

- 2) Economists also assume that economic growth has a positive effect for constraining tax evasion in the long run. Supported by empirical studies, these authors claim that economic growth has (on average) a positive (long term) impact on several economic, institutional and social aspects and ultimately also on tax evasion and non-compliance. One argument is for example that economic growth fosters state capacity which in turns increases administrative capacity the ability to administer taxes which in turn will lead to a reduction of the shadow economy and thus a reduction in tax evasion.
- 3) Especially for the transnational component of tax non-compliance the intersection of a country into the global economy is decisive. All aspects discussed in Unit 8 - competition for capital investment, the relevance of investment treaties, and the role of tax havens - have an important impact on the amount of tax non-compliance, particularly in the case of the taxation of mobile capital and in the case of tax payers who have the means to take advantage of global tax competition.

Broadening this perspective, high levels of tax non-compliance can be connected to what is discussed in Unit 10, i.e. the specific intersection of Latin American countries into global market via the exportation of non-renewable products. Here various critical aspects interrelate. Companies in the extractive industry are mostly transnational or state controlled. Taxation of the extractive sector is complex, includes various tradeoffs and entails more knowledge and technical expertise, thus requiring highly capable tax agencies. In addition, most Latin American countries are bound to trade agreements and investment treaties which interfere with the operation of these companies. Finally, as this industry is seen as strategic and entails high capital investment management, extractive industries are prone to illegal political activities such as corruption or bribery with negative effects on tax collection.

Tax legislation, administration and design

Tax system transparency is said to have a positive effect towards tax compliance and acceptance. Most public finance scholars therefore agree that a transparent tax legislation helps a) tax payers to comply with their tax dues and b) enables tax administrations to collect revenue successfully and control tax payers. This said, authors highlight additional aspects related to tax legislation, administration and design:

- In Latin America, tax agencies have made significant progress in terms of funding, professionalization of staff and management and exchange of information (Gómez Sabaini and Jiménez, 2011). All these achievements, although with room for improvement, have increased their efficiency and their capacity of control and auditing of the taxpayers. Indeed, the literature highlights the proper functioning of tax administration as crucial to fight tax evasion. This includes organizational and technical aspects, digital infrastructure and personal, political independence as well as cross-country cooperation.
- Tax design and legislation also has been identified as being crucial to tackling tax non-compliance. Complexity increases costs of control of administration and control. Frequent changes in tax codes challenge administrations to re-adapt and challenge tax payers to understand and comply with the new rules. In certain cases over-regulation can be a severe problem which pushes small business into illegality.

Based on this argument, almost all Latin American governments have introduced simplified tax regimes for micro companies or small and medium businesses. These regimes aim to enable them to better comply with their tax obligations at a reduced rate and with a reduced amount of administrative costs. However, the success of these simplified tax regimes, termed differently in the region e.g. Monotributo in Argentina, has been questioned for various reasons. In any way, the large informal sector remains a challenge also for the revenue system, as not only VAT but also CIT, other corporate taxes and especially social security contributions are evaded. Besides this initiative, tax design is one of the principal topics of public finance scholarship following the rationale of optimal tax theory.

- In countries which are prone to corruption, clientelism and a lack of the rule of law, politicians or public authorities can exploit their positions to grant tax exemptions in return for direct payments or services. Indeed, studies show that corruption and tax non-compliance are interrelated. In a more general perspective this means that there are interrelated challenges to fight tax evasion which may have to do with corruption, rule of law, governance and administration.

Macro institutional explanations

Relating levels of tax evasion to wider social and political phenomena is the core argument of macro institutional explanations to tax non-compliance. Here the literature refers to topics discussed in Units 3, 4 and 5:

For example, the question of fiscal contract: where public service provision is of poor quality or absent, high tax burdens are expected to spur evasion as the implicit contract of tax payments for public services is broken. Generally, it is assumed that individuals will be more willing to comply with government tax policy if they expect that the benefits for them, or their peer groups, in the form of a higher level of expenditures will roughly match or exceed the corresponding increase in their tax liabilities.

Other authors assume that tax evasion also has to do with political participation. That is if individuals can participate in a political community there are more willing to contribute to this community (thus paying their tax dues). The idea behind this is that via participation, the legitimacy as well as the accountability of the political community increases.

Other arguments refer to the behavior of others: the idea is that if tax payers are aware that other tax payers do not pay their taxes they are more willing to do the same. Tax evasion is socially accepted and may even be socially and discursively rewarded.

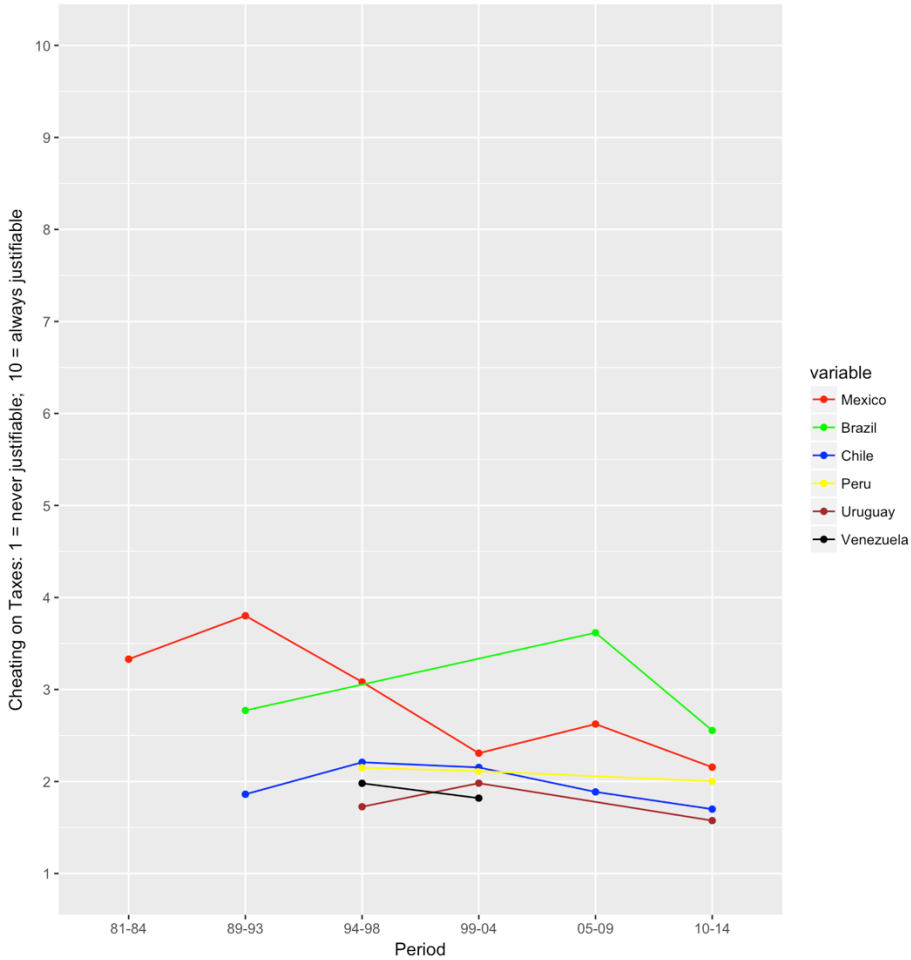
The idea of tax morals tries to combine the influence of all of these factors – governance, participation, legitimation, accountability and collectively shared norms – within one concept. Tax morals describes the willingness of a tax payer to comply with the given norms. Studies that use this concept show that tax morals can explain tax evasion (Torgler, 2007).

However, the question remains how to measure it. Here frequently studies make use of survey data or other proxies. Figure 9.4 shows an indicator for tax morals from the World Value Survey, one of the few surveys which includes both time series data and non-industrialized countries. As a proxy to the level of tax morals, the mean response to the question if cheating on taxes is justifiable on a 1 to 10 scale is indicated. Clearly, from this measure we cannot deduce the actual degree of tax evasion but it may be possible to observe shared norms and perspectives on taxation within society. Still, there are some downsides to the use of survey data: this kind of data neither captures any deeper sub-text nor offers room for clarifications from the respondents' replies; it rather provides a snapshot view of individuals' attitudes and behavior. While this snapshot may change with changing circumstances, different questionnaires or other circumstances (survey design is something researchers should be aware of) it is still one of the few opportunities to obtain micro-level data which is reasonably comparable across countries. Works based on this data can thus provide another angle of the dynamics of tax morals.

Cross-country research claims that tax morals are influenced by structural economic variables (economic crisis, depression, or a large informal sector), state capacity and quality of

government (services, bureaucratic capacity, etc.) but also may have to do with micro-level perceptions of quality of public services, state accountability but also social status. This shows that the concept of tax morals may be useful but the operationalization of it is still questionable and consistent time series survey data for all Latin American countries is still rare.

Figure 9.4 Tax Morals Indicator, World Value Survey, 6 Latin American Countries, 1981-2014



Source: Own elaboration with data from World Value Survey: <http://www.worldvaluessurvey.org>

Mean response to question: Is cheating on taxes justifiable? 1 = Never justifiable, 10 = always justifiable.

In general, high levels of tax evasion can hardly be reduced quickly. In order to explain this persistence, the idea to think levels of tax evasion in terms of equilibria is useful. A certain equilibria of tax non-compliance may arise for example if norms of non-compliance is collectively accepted and shared, including dominant views on an exploitive state or wide misuse of public funds and corruption. Once such equilibrium of norms, perceptions and habits is found it requires more than simple policy changes to fight evasion, but include wider measures to change the perceptions, norms and habits of taxpayers.

Behavioral explanations

The behavior of tax payers is also the focus of studies that focus on the micro sociological or individual level. Here research on tax evasion is influenced from different disciplines: economics, sociology, psychology, neuroscience or other areas with the aim to explain human behavior. Frequently, such studies make use of surveys, tax data, experiments or other methodological approaches which allow them to trace the behavior of individuals within a specific setting. For example, orthodox schools have attributed tax compliance to the taxpayer's fear of being caught and punished by authority (Allingham and Sandmo 1972). However, such explanations do not account for states in which the probability of sanction and audit is very low but, paradoxically, the compliance level is very high.

Consequently, tax compliance is a phenomenon that, although possibly dependent on control and sanction, is also influenced by multiple factors, including those of a subjective nature. Such personal attitudes towards tax compliance can be influenced by collectively shared norms and values, contextual factors, procedural aspects or even knowledge of taxation. Yet, these studies often find explanations at the micro-level which are not always easy to generalize and derive policy proposals from them. Maybe the most prominent and at the same time creative policy linked to these approaches is the idea to reward consumers with lottery tickets printed on the receipts they obtain when purchasing goods. As issuing these tickets would mean that businesses would document sales and thus include VAT, the behavioral incentives of winning in a lottery increases tax compliance. Today such tax ticket lotteries exist in numerous countries such as China, Thailand, Portugal, etc.

Group Exercise:

Student groups of 2-5 students get together and compile information about tax non-compliance and tax attitudes in an Andean country of its choice. Data on tax attitudes/tax morals may be obtained from the last round of *Latinobarometro* in the Andean country of their choice. Based on this data students can explore the relationship of this indicator with other measures (income, participation, etc.) in the survey. Alternatively, students can use data from the World Value Survey, where online analysis is possible. Within their group they can discuss if their results can help them to explain tax non-compliance and if their results are in line with the proposition of variables influencing tax morals. Student groups can share the results of their work with the class.

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Unit 10: Taxation of Non-renewable Natural Resources

The dependence on natural resources is an enduring reality in Latin American economies and public finances. This dependency has, thanks to the commodity boom and the reprimatisation (*reprimatisación*) of Latin American economies, increased since the turn of the century. As a consequence, revenues from the extraction and sale of non-renewable resources make up an important share of state budgets in several countries. This unit reviews the literature highlighting the economic, socio-political and ecological challenges which are connected to the fiscal reliance on taxation of extractive industries (resource curse, price volatility, economic shocks, and ecological impact) and provides students with an overview of the current situation of natural resource taxation in the region. Students become aware of the advantages and disadvantages of the distinctive country approaches of taxing extractive industries and the consequences these entail. In the end, students should be able to discuss the advantages and disadvantages of specific revenue instruments applied to the extractive sector.

Learning goals:

- Students will be able to assess revenue instruments (tax and non-tax) applied to levy the extraction of non-renewable natural resources.
- Students will become familiar with the importance of revenues from non-renewable natural resource extraction in Latin America.
- Students will become familiar with the political, ecological and economic consequences of high dependence on fiscal revenues from non-renewable natural resources.

10.1 The context of revenue instruments applied to extractive industries

Converting a country's wealth in natural resource into public revenue is not as easy as it may appear at first glance. Different than in other economic sectors, only few companies are engaged in the extraction of non-renewable natural resources, extraction takes place at fixed sites with high capital investments and the domestic commodity chains are limited as products are frequently produced for export. These are all factors which should facilitate tax collection, nevertheless taxing the extractive sectors appears to be challenging and studies show that developing countries seldom take full advantage of the revenue potential of non-renewable resources (IMF 2012). Once the decision to allow the extraction of non-renewable resources is taken, public authorities have to balance several conflicting interests and make choices with competing short-term vs. long-term results in choosing the right (combination of) revenue instrument(s). In addition, although in theory there may be an optimal mode to pursue, in practice the choice which revenue instruments are applied in a given country is the result of a political process, which in itself is contingent upon historic, political and social circumstances (i.e. politics).

Political actors face several dilemmas, particularly if we remember that most Latin American capitalist economies are of a hierarchical nature including a high concentration of capital, few powerful business groups, a historical lack of (domestic) capital, and face significant spending

needs due to social grievances (high inequality, deficient social security systems, etc.). In addition, to these structural features of Latin American economies with respect to the extractive sector, they often lack sufficient technical expertise and a record of low institutional and regulatory capacity is common. Coupled with high macro-economic volatility these features make non-renewable resource taxation and fiscal policy in general less stable and more complex and conflictive.

Choosing the right fiscal regime for the taxation of the extractive industry frequently includes questions of risk-sharing between private investors (companies) and the public authorities: Extraction of non-renewable resources usually demands high up-front investment governments don't want to or cannot spend as well as technical expertise and capacity public companies do not have. Private companies can provide both of these resources but need assurances that their investment will turn profitable over time. This results in possible insecurity on both sides. Private companies frequently face high sunk costs (up-front investment outlays before product is extracted and sold), which may not be cashed in if the project is terminated. In terms of negotiating power once these costs are sunk (spent) the balance of power shifts from the investor to the host government. Before the start of extraction project, even the best-intentioned government has an incentive to offer attractive fiscal terms, but afterwards—as the tax base becomes much less elastic—authorities may want to change the fiscal terms to its favor. This can result in a “hold-up” problem; investors feel that the risk for their investment is too high due to possible modifications in the fiscal regime which discourages investment in the first place. In addition, as commodity prices are volatile, private investors – as well as the public authorities (see above) – have to include risks related to volatile prices in their investment decision. Finally, potential exhaustibility of deposits can be a concern for private investors. At the project level, exhaustibility is a key opportunity cost, as extracting today means that future extraction is foregone. In sum, private investors have an interest in a fiscal regime which is stable and enables them to extract as much profit as possible from their investment.

Governments on the other hand face the risk of underexploring possible fiscal rents if their confidence in private companies is unrestricted. Public authorities may underestimate problems related to asymmetric information. Private investors undertaking exploration and development are likely to be better informed than host governments on technical and commercial aspects of a project and the likely real output. Public authorities can misjudge the project potential and select a fiscal regime with sub-optimal allocation. Another risk government face to control extractive companies is associated with sector specific factors. First, private companies are mostly transnational. This can raise complex tax issues - with multinationals likely having more expertise than most developing country administrations - and sensitivities regarding sharing the benefits from national resources. Taxation of transnationally operating companies may be restricted due to multilateral or bilateral investment treaties signed by the host country. In addition, changes in the fiscal regime, production sharing contracts or even nationalization of private companies can result in legal demands by multinationals in international trade courts (see also Unit 8).

Secondly, producers may have substantial market power as they control a significant part of global deposits. In mining, for example, most internationally traded supplies of iron ore are shipped by just three companies. Market power can be related to price dynamics as well as technical expertise and increases the bargaining power of private investors. Some of these concerns of asymmetric information and control can be circumvented by state owned enterprises. i.e. nationalization of resource extraction. But such enterprises raise other questions, such as the efficiency of operations, the allocation of taxing responsibilities and political influence. In sum, public authorities favor a flexible and easy to administer fiscal regime, which provides a stable and maximum amount of revenue and is responsive to rises in commodity prices (i.e. higher prices, higher revenue).

As can be seen, the private and the public side both face risks in engaging in the extraction of non-renewable resources and have different preferences concerning the fiscal regime. Fiscal instruments are likely to influence the balance of risk taking and shift investment risk either to the private or public actors. However, there is no uniform solution for applying the right fiscal instrument. Not only do investments depend on local and national conditions or market and price dynamics, there are also differences between the sectors, i.e. the mining and hydrocarbon sector. Three of them are worth mentioning and may explain the differences in fiscal regimes in the both sectors. First, the exploration is often costly and riskier for petroleum. A deep water well, for instance, can cost over US\$100 million, and the chance of success in a new basin may be 1 in 20 or less (IMF 2012). But the risks in the ‘development’ phase (bringing a discovery to extraction), and of failure during the extraction phase, may be greater for mining. Mining may also involve greater political and environmental risks: mines are typically based on land rather than offshore and may have a significant environmental impact (*minería a cielo abierto*). Secondly, commercial structures tend to differ between petroleum and mining. For tax, financing, or sometimes technological reasons, unincorporated joint ventures (UJV) have been common in petroleum projects, with capital separately provided by the partners and production shared. This sets up conflicting interests from which tax authorities can benefit in controlling costs. UJVs have been much less common in mining, with major companies owning majority stakes in locally-incorporated vehicles. Finally, the extractive sectors are changing and new technologies are affecting exploration activities. This is especially true for the hydrocarbon sector where the “fracking” technology (hydraulic fracturing), enabled a fuller or new exploitation of onshore unconventional oil and gas deposits. These dynamics do not only affect long term price trends or production costs; they also raise new issues of social and environmental concerns which states have to balance. In sum, these major differences highlight the need for sector specific application of fiscal instruments.

Given this background it is possible to understand the trade-offs public authorities face in choosing the right fiscal regime. In the government’s ideal scenario, a fiscal instrument should comply with several goals. Governments wish a fiscal regime that:

- Provides stable fiscal revenues. This is important for governments as they want to have a sustainable revenue base upon which they can plan. However, given the price volatility in commodity markets, stable revenues are seldom assured.

- Has low administrative costs. Although there are only few companies in the extractive sectors monitoring all of them can be costly and complex. Given that tax authorities in most developing countries already struggle to fight tax evasion in other areas (Unit 9) the supervision of a complex fiscal regime may challenge tax authorities.
- Results in high compliance by tax payers. Tax avoidance is a major concern in every Latin American country (Unit 9) and also present in the extractive sectors, as transnational companies have the ability to engage in aggressive tax planning strategies. For example, in the case of Peru a recent study by Ojo Publico highlighted significant revenue loss due to tax avoidance by mining companies (Ojo Publico 2016).
- Is efficient (Unit 1).
- Is neutral in the sense that the revenue generation avoids distorting investment and operating decisions and thereby dissipate the revenue potential (Unit 1).
- Is progressive. Progressivity has a different meaning than discussing the income tax (Unit 7). It can either be used to describe the extent to which revenue increases as the price of the commodity rises or production costs fall (i.e. it shapes the sharing of risk between the private and state side).⁶ It can also be used within a time dimension, expressing how the present value (PV) of taxes varies with the lifetime PV of a project.
- Minimize government risk.

Given the particularities of the extractive sector, achieving all of these goals with one fiscal instrument is unlikely. For example, there is a permanent tension between the objectives of maintaining reasonable investment dynamism and achieving, at the same time, a progressive state participation in economic rents derived from natural resource extraction. In this sense, some balance is required between them, in particular referring to efficiency, equity, and fiscal revenue collection and administrative and compliance costs. Each fiscal instrument has different implications for these competing goals. It also will affect the balance of risk taking between the government and the private sector as discussed before.

10.2 Fiscal instruments (tax and non-tax) applied to extractive industries

There are several fiscal instruments which can be applied at extractive industries. Frequently, multiple instruments can be found in one country and countries may change the instruments applied. The table prepared by the IMF (2015): 16 (see <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>). lists the major instruments which are of relevance in countries with important extractive industries.

Principally, these instruments can be classified following two major divisions: 1) What is taxed? In other words, to what is the fiscal instrument being applied? A division can be made between those instruments levied upon earnings (or any definition of income net of related costs) of the extractive company against those that are determined by the physical amount or the economic value of production, regardless whether they fall on reserves or on inputs and

⁶ Tax efficiency requires that more risk be borne by the party better able to bear it. In developing country contexts, this may often be private investors, given their ability to diversify across deposits (though the exposure of even large multinationals to single large projects should not be underestimated).

services used in the exploitation. 2) Does the state participate actively or passively in the production?

In general terms one can distinguish seven different instruments (see also IMF 2012). The specific characteristics of these instruments may vary considerably between each specific country:

- Production sharing: Is a fiscal scheme for extraction of natural resources (mostly petroleum, gas) in which production at a surface delivery point is shared between a state entity and a private contractor. Production sharing can take different forms in applying:
 - (a) A fixed production share;
 - (b) Based on the daily rate of production (DROP): Here the government share of profit petroleum increases with the daily rate of production from the field or license, often with several tiers;
 - (c) Cumulative production from the project: In this case the government share of profit petroleum increases as total cumulative production increases;
 - (d) R-Factor production sharing scheme: government's profit share increases with the ratio of contractor's cumulative revenues to contractor's costs (the "R factor"). It is said that this scheme improves on a DROP scheme in being a more direct measure of profitability, but at the same time, it does not recognize the time value of money;
 - (e) Rate of return (ROR): Government's share of profit petroleum is set by reference to the cumulative contractor rate of return.
- Fixed charges or fees.
- Bonus: Bonuses are single (or sometimes staged) lump sum payments paid by a company, frequently for rights for extraction. Bonuses can be set in legislation or negotiated, and could be biddable (auction). Signature bonuses become a sunk cost for companies that they may recover only in the event of successful development, and even then, the fact that they are sunk may pose new political risk if a project is especially profitable.⁷
- Royalty: A charge for the extraction of natural resources (mostly minerals) by a company (specific amount per unit of volume). Usually it is calculated *ad valorem*, a percentage of gross revenues (fixed royalty *ad valorem*). It can also be a specific charge by volume or weight of production (fixed royalty production). Royalties can also vary with price (contingent royalties), with production, operating ratio/profit. It can also be applied to the operating margin (net profits royalty).⁸
- Indirect Taxation (VAT, export tariffs): VAT, if companies, sectors or regions, are not exempted, applies to all companies in the extractive industry as to other domestic companies. Note that, VAT, as discussed in Unit 1 can, under certain circumstances, be passed to consumers of the commodities produced. Tariffs on the other hand are said to be very easy to administer, as the control of commodities leaving or entering the country requires less state intervention. Although tariffs have been one of the standard fiscal

⁷ Bonuses in some petroleum exploration rights auctions have been very large (over \$1 billion as a top bid in Angola's 2006 round) but are much more modest, for example, in the USA's offshore auctions. In Latin America, the latest auction has taken place in Mexico in 2016/7.

⁸ Term also used in "net profits royalty" where some costs are deducted, in which case similar to an income or rent tax.

instruments applied to extractive industries in the beginning of the 20th century in Latin America and much of the world, due to the increasing deregulation of world trade they have long played a marginal role (until the Trump presidency).

- Corporate income taxes: CIT to the EIs can ensure that the normal return to equity is taxed at corporate level just as in other sectors. Note that some countries apply a higher than standard rate on the usual CIT base; others have separate income tax regimes addressing sector-specific issues. There are also some special options such as a variable income tax (VIT), which uses the CIT base, but varies the rate of tax according to the ratio of profits to gross revenues. Note that in some cases (notably the U.S. and Canada) provincial CIT can additionally be applied. In recent times, there has been special attention to problems of profit shifting related to the corporate income tax by transnational enterprises (Unit 8). Profit shifting occurs when companies transfer their profits to subsidiaries of the same enterprise in low income tax countries and avoid payment of domestic income tax in the higher income tax countries. This mechanism is viable for companies operating in the extractive sector.
- Diverse forms of state ownership: In some cases, the state participates actively in the extractive industries via different forms of state ownership. State participation can have various forms. Extraction of minerals or oil can be pursued by state owned enterprises (such as in the case of Chile (CODELCO) or Venezuela (PDVSA)). State participation can be rooted in historical circumstances and based on strong traditions. Take the decision of nationalization of the oil industry in Mexico by President Lázaro Cárdenas in 1939 which was implemented in the Mexican Constitution and only recently removed in 2012. State ownership of oil industry is standard in many Middle Eastern countries, notably Iraq, Kuwait, and Saudi Arabia. State ownership of extractive companies can lead to state revenues via different mechanisms:
 - the government receives percentage of dividends without payment of any costs (Free equity);
 - government contributions received by investors and recovered from dividends with interest (Carried equity);
 - the government pays its share of costs (Paid equity).Standard arguments against state owned enterprise are concerns about efficiency or forms of political “use”, e.g. via patronage and political corruption. To explore such arguments the discussion on the liberalization of the oil and the capitalization problems of the state-owned PEMEX are enlightening.

10.3 Characteristics of fiscal instruments applied to extractive industries

Each instrument has its advantages and disadvantages with respect to the impact on tax neutrality and effectiveness, investor behavior, the sharing of risk between the government and investor, the administrative and compliance costs and for securing stable long term revenues. In addition, the instruments have different impact on progressivity.

The table prepared by the IMF (2015): 16 (see <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>). shows how these fiscal

instruments relate to some of the defined goals. For example, royalties, a frequently used instrument in the mining sector, are – in their simplest form – easy to administer but they are regressive and entail risks for governments to correctly measure and value the extracted resources. Soon it becomes clear that there is no gold standard in taxing extractive industries.

10.4 Revenues from non-renewable resource in Latin America

Latin America provides 11.2% of global oil production in the year 2015 and possesses almost 20% of the world's proved oil reserves. Meanwhile Chile and Peru together provide 39% of the world copper production.⁹ In addition, there are several countries in Latin America with a very high share of non-renewable resource products in total exports. Countries whose export basket is dominated by mineral and oil products include Chile, Colombia, Ecuador, Peru and Venezuela.

Scholars interested in the export composition of Latin American countries can consult data from two classification systems: the UN-COMTRADE Harmonized System (HS) and the Standard International Trade Classification (SITC). Table 10.1 below provides one way to calculate the total amount of commodity exports products via the SITC. Independent of which classification system is used the analysis of contemporary Latin American exports reveals that a high reliance on commodity exports dominates. For example, in the year 2014 among the top 25 economies with the highest net primary commodity exports 11 Latin American countries (note that Venezuela is not included) are listed. The high dependence on commodity export is also visible in a historical perspective. Although the share of commodity exports is not as high as in the early 1960s such exports constitute still the major share in the export basket. Yet there are different patterns agricultural exports are traditionally of special importance in Argentina and Brazil, while minerals in Chile and Peru and hydrocarbons in Colombia and Venezuela. Mexico is somehow the exception as commodity exports lost importance since the 1980s with the change of the development model of the country. To learn more about the composition of exports in Latin American countries students can consult the online tool “The Atlas of Economic Complexity” provided by the Center for International Development at Harvard University: <https://tinyurl.com/ya6oq3zo>.

⁹ The largest share goes for Chile with the 31% of the total world production.

Table 10.1 Definition Primary Commodities, SIC

Energy	Metals	Agriculture
SITC 3	SITC 27,28 and 68	SITC 0,1,2 and 4
includes (not exclusively)		
Oil Natural Gas	Copper Aluminum Iron ore Nickel Zinc Lead Silver	Food and live animals (e.g. soybeans) Beverages and tobacco Animal and vegetable oils, fats and waxes (e.g. soybean oil)

Source: Own elaboration, Standard International Trade Classification

The budget of most Latin American economies reflects this commodity export dependence. Public budgets of several countries in Latin America are highly depended on revenues from natural resources. Table 10.2 shows that this dependence is particularly relevant in oil exporting countries Ecuador, Mexico (over 30% of revenues are due to the extractive industry) and countries with an important mining industry such as Colombia, Peru and Chile (around 15%).

As we can appreciate from Table 10.2, the fiscal dependence on revenues from extractive industries remains significant in several Latin American countries since the beginning of the 21st century. This is true for the period of the commodity boom, in which commodity prices were exceptionally high, as well as for the contemporary period (2010-2014) in which global economic uncertainty has increased and commodity prices have deteriorated. Still the importance of commodity related revenues is different in Latin America. In some countries, namely Colombia and Ecuador, the importance of these commodities has increased making their fiscal position more exposed to global price volatilities. In other countries, Peru and Argentina, this exposure has reached its peak in the period of high prices, 2005-2008, and decreased in the contemporary period.

Table 10.2, Selected Latin American countries, share of PIB and share of total revenue generated by production of hydrocarbons and minerals, 2000-2014 (%)

Country	As share of the countries' GDP			As share of total fiscal revenue		
	2000-2003	2005-2008	2010-2014	2000-2003	2005-2008	2010-2014
Argentina <i>hydrocarbons</i>	0.8	1.6	1	4.5	7.3	3.4
Argentina <i>minerals</i>	0	0.1	0.1	0	0.4	0.4
Argentina	0.8	1.7	1.1	4.5	7.7	3.8
Colombia <i>hydrocarbons</i>	1.6	2.4	3.4	5.6	8.2	12
Colombia <i>minerals</i>	0.2	0.5	0.4	0.5	1.5	1.3
Colombia	1.8	2.9	3.8	6.1	9.7	13.3
Ecuador <i>hydrocarbons</i>	5.7	8.7	12.8	29.3	35.3	38.2
Ecuador	5.7	8.7	12.8	29.3	35.3	38.2
Mexico ^a <i>hydrocarbons</i>	3	5.9	5.3	21.1	38.3	32.7
México <i>minerals</i>	0	0.1	0.2	0.3	0.8	1
México	3	6	5.5	21.4	39.1	33.7
Peru <i>hydrocarbons</i>	0.5	1.1	1.4	3.2	5.9	6.9
Peru <i>minerals</i>	0.2	2.1	1.3	1	10.6	6.4
Peru	0.7	3.2	2.7	4.2	16.5	13.3
Chile <i>minerals</i>	0.8	6.9	3	4	28.1	13.8
Chile	0.8	6.9	3	4	28.1	13.8

Source: Own elaboration with data from Economic Commission of Latin America and the Caribbean, ECALC

^a Does not include own income of the state owned petro company PEMEX.

10.5 Fiscal instruments applied to extractive industries in Latin America

How do Latin American countries tax extractive industries? Over the past decades a strong diversification in the range of fiscal instruments -both tax and non-tax- took place in extractive industries in most countries in the region. These instruments include royalties; resource rent taxes, windfall taxes, corporate income taxes and diverse forms of state ownership. However, there are significant differences, as shown in the descriptions of the fiscal regimes in nine Latin American countries in Table 4 (*Cuadro 4*) of Rossignoli 2015: 47 (<https://repositorio.cepal.org/handle/11362/39625>).

Related to the discussion above, this can be explained by the differing objectives governments want to reach. It may also have to do with the circumstances in a given country. For example, countries which host many projects, or with strong credit market access, may be less

concerned about ensuring early payment by each company in isolation. Or those with ready access to alternative sources of revenue may be less concerned by risk-sharing. In addition, political pressures to show acceptable revenue from national assets, acceptably responsive to current prices, can be powerful. For example, as the experience in Argentina and Bolivia shows, governments were able to reach broad public support in re-nationalization of extractive companies. On the other hand, in some countries lobbying efforts of companies in the extractive sector have been fruitful and effective taxation of extractive industries is still in its footsteps, such as in the Central American countries.

Since the year 2002, Latin American countries have made several important changes – tax and non-tax – to the fiscal governance of the extractive sector. The principal motivation behind these changes was to benefit from the extraordinary windfall profits caused by unseen high and stable commodity prices. Without describing the particular details of these changes in every country these measures included:

- Several reforms were pursued to re-gain state control of non-renewable natural resources, principally in the hydrocarbon sector. Such reforms included the nationalization of the sector, re-negotiation of contracts or the nationalization of companies or mines and could be observed in Venezuela (2005-2007), Bolivia (2006, 2012), Ecuador (2010).
- Except for Peru, all countries now participate directly in the extractive sector via state owned enterprises, although in Mexico the recent reform (2012) of the oil regime ends with the monopoly of the state-owned PEMEX. Often, these companies are subject to special tax regimes, including additional income or production taxes and other additional payments.
- Given the high prices in mining products countries also reformed their system of royalties, often including variable rates and scales. This was the case in Bolivia (2005), Ecuador (2010), Colombia (2011) and Peru (2011).
- Also, new fiscal instruments to the extractive sector were enacted during the commodity boom (2005-2013). For example, *Impuesto Directo a los Hidrocarburos* in Bolivia, *Impuesto Específico a la Actividad Minera* in Chile, rise in rates of the *Impuesto sobre la Renta del petróleo* (up to 50%) in Venezuela or the *Impuesto Especial a la Minería and the Gravamen Especial a la Minería* in Perú. Other countries opted to install levies on extraordinary utilities as in Colombia, Ecuador or Trinidad y Tobago, principally in the oil industry.
- In general, during this period, advances in the progressivity of fiscal regimes can be observed, although in a more consistent way in the hydrocarbon sector than in the mining sector.
- However, given the fall in prices, several countries have put an end or reversed the higher taxation of the extractive industries. Examples include Mexico or Argentina where export

taxes have been dismantled or tax regimes adapted. Falling prices always entail claims by producers that the profitability of their projects is no longer secured and that taxation may pose at risk employment and extraction.

10.6 Economic, political and social consequences of fiscal dependence on non-renewable resource revenues

A high fiscal dependence on non-renewable resources can have several negative political, economic, social and environmental consequences. Such dependence is not only frequent in Latin America but also observable in Africa and Asia and is for many countries a historical constant. This is why the literature on the development perspective of commodity exporting countries is old and manifold. Although empirically there are countries which have successfully transformed from a commodity based economy to an industrialized economy (South Korea, etc.), high dependence on natural resources is still seen as a major challenge to economic development, especially if such dependence is not adequately managed. Without the claim of completeness, this Unit proposes to treat some of the main debates surrounding resource dependence and public finances.

- Fiscal sustainability and macroeconomic volatility

After more than a decade of fiscal and economic bonanza commodity prices in Latin America eventually tumbled in 2015 and so did economic and fiscal indicators in almost all countries in the region. This highlights the importance of macroeconomic volatility for economic and fiscal regimes in the region. In fact, in Latin American countries the volatility of commodity prices is one of the principal determinants of fiscal revenues and threatens fiscal sustainability. Macroeconomic volatility of main export products is especially important for Latin American countries. This is because: a) it has increased contemporary importance. In several countries, the relative share of collected revenues based on extractive activity increased in the 21st century (e.g. Colombia, Ecuador) or remained high (Mexico, Venezuela, etc.) b) macroeconomic volatility is almost a historical constant in the region and has shaped Latin American economies producing boom and bust cycles and has gained Latin America the reputation as the most crisis-ridden continent. Crisis on the other hand had negative social, political and public spending effects but also has marked the development of the fiscal and tax regimes, due to ad-hoc policy responses of short term solutions to fiscal deficits.

In the public finance literature on Latin America this caused a focus on several topics: a) How should tax and fiscal regimes be designed to effectively confront macroeconomic volatility. Here topics as automatic stabilizers, diversification of revenue and an increase of direct taxes, but also fiscal stabilization funds are explored; b) How should fiscal policy change along macroeconomic cycles? Here the design of counter-cyclical fiscal policy, and the political economy of post-crisis tax reforms are debated aspects.

- *Dutch disease*

Since the very beginning of development economics economists have tried to understand the effects of commodity dependence for economic development. As economic dependence on natural resources was linked to underdevelopment and industrialization was regarded as the only way to reach development, one principal concern has been to explore the conditions under which the transition from a commodity based economy towards an industrialized economy can be best achieved (see Ross 1999 for a short revision). While in the 1950s abundance in natural resources was seen as a benefit, especially by scholars linked to the tradition of modernization theory (because states could overcome capital shortfalls thanks to commodity exportation and attraction of FDI, government revenue collection should be easier and more public goods could be financed) since the 1960s and 1970s, and especially after the price shocks in the 1980s, commodity abundance was viewed much more critically. In addition, based on empirical investigations, scholars concluded that economic growth was less stable and strong in economies with natural resource abundance than in economies without this feature. Suddenly, the arguments of structural economists, which highlighted the unfavorable terms of trades of commodity exporting countries, gained popularity. Other authors blamed the high economic volatility linked to commodity exports. Still, others pointed to the limited forward and backward linkages commodity exports would create with other economic sectors, both harmful for economic development.

In fiscal terms, these arguments pointed to the fact that commodity dependence generate *too little* public revenue from their exports. In an opposing standpoint, another argument points to the fact that natural resource abundance may lead, via a boom in exports, to economic stagnation via the generation of *too much* revenue, particularly in foreign reserves. This effect, termed, the *Dutch Disease*, describes a combination of two effects: the appreciation of the country's real exchange rate caused by the sharp rise in exports: and, second, the tendency that in an economic boom period the resource sector draws capital away from the manufacturing and agricultural sectors, thus raising production costs. Together this would result in a decline of the manufacturing and agricultural sector and inflate the costs for goods and services which cannot be imported. Although much in vogue in the 1980s this argument has turned out to be relatively rare in developing countries and the model is built on some flawed basic assumptions (fixed capital and labor supply, perfect substitution of domestic and imported goods, etc.) that rarely hold in practice (see Ross 1999: 306).

In sum, neither of these arguments was convincing to explain the comparatively less favorable economic development of resource rich economies. This anomaly, the fact that natural resource rich economies grow less, was termed the '*resource curse*' and in the following years the economic literature on the resource curse has, next to the exploration of specific economic effects of resource abundance focused on the political economy of the resource curse. In other words, scholars gave more attention to factors of the political system which prevent governments to "handle" successfully the resource abundance in terms of economic development. This was deemed necessary as some resource rich countries like Norway managed the resource curse very favorable while others (in Africa, Latin America or elsewhere) did not.

- *Political economy considerations of resource curse & rentier state theory*

In the political science and political economy literature, the availability of abundant natural resources was linked with state capacity, state building and forms of representation (see also Unit 3 & Unit 4). This literature argued that the "*resource curse*" of developing countries pose a threat to state building, political participation and government accountability. The prime example of all ills which come hand in hand with the resource abundance are autocratic political regimes in the Arab world (Saudi Arabia, Kuwait, but also recently Venezuela). Such regimes, which seemed to survive thanks to almost unstoppable fiscal flows from natural resources, were termed *rentier states*. Rentier states combined all the ills western scholars did not label as modern: low accountability of public authorities, no political participation and stable autocratic rule, excessive and ineffective state apparatus, low economic productivity in non-extractive sectors, etc.). However, the classic rentier state literature (from political science) as well as the resource curse literature largely failed to engage in micro-level analysis to explain variation among resource rich countries in terms of policies, government and (fiscal and economic) development. Current research suggests that this general idea of a resource curse itself is misleading and that the internal constellations of actors, especially between different elite groups in specific economic cycles have to be taken into account in order to explain the different trajectories of such countries.

A side topic of the resource curse literature has to do with political and violent conflict, such as civil wars. These contributions are especially relevant for African countries that assume that resource abundance in some regions can propel, foment or prolong violent conflict under certain instances. As natural resources are highly demanded abroad, extraction can be converted into desperately needed cash to maintain or gain military power. In the case of Latin America, natural resource conflict in contrast has much more to do with local mobilizations against labor exploitation, environmental contamination, threats to self-determination of local communities and their rights or as a sign of political protest to attract national attention and influence.

- *Commodity dependence and tax reform*

The policy reform literature is interested in the incentives generated by natural resource abundance for governments. The main idea in these contributions is that if governments gain the impression that they can rely on a steady stream of fiscal revenue thanks to abundance in non-renewable natural resources, they become uninterested in revenue raising tax reform and diversification of the tax system. Natural resource abundance is thus expected to reduce the likelihood of revenue raising tax reform. In Latin America, this hypothesis does not hold empirically in a comparative perspective, as quantitative studies confirm (Unit 6). However fiscal and economic crisis related to commodity price cycles do have an impact on the likelihood of reform or the perception and planning of governments.

- *Environmental, territorial and social challenges*

Finally, although these are not primarily fiscal challenges one should not forget that natural resource extraction is likely to have negative effects on the environment and affected local groups, which challenge the possible fiscal benefits of extraction. In fiscal terms, one of the

main debates here surrounds the topic of compensation. Compensation is meant in terms of balancing local or regional fiscal participation vs. nationwide fiscal participation (see Unit 11), or in the form of counterbalancing environmental damage (e.g. the investment of extractive companies in environmental projects) or in global terms (take the example of the TIPNIS initiative of Ecuador). All these debates show that taxing extractive industries has to confront not only fiscal goals but also social and environmental ones.

Group exercise:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if more groups than countries, groups can select other Latin American countries). The task for each group is to elaborate a short country report of natural resource taxation in the country in question. What are the effects of this type of tax regime, who bears the risk, what are the outcomes? On which grounds this tax regime may be criticized. Groups should present the report in front of class and discuss the advantages and disadvantages of this experience with the public.

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Unit 11: Challenges to Local and Subnational Taxation in Latin America

In many Latin American countries, local and regional governments play an important role in fiscal policy. Although in a comparative perspective, subnational governments other than in Brazil lack significant tax authority, expenditure decentralization has increased significantly since the 1980s. This poses several challenges of management and coordination between legal jurisdictions (national, regional, local) and within nation states in terms of tax policy, revenue distribution and tax and spending authority. Not all of these challenges have been successfully addressed and many open questions still exist in the region.

This unit aims to give an overview of the multiple ways taxation and fiscal decentralization is organized in the region and the challenges that exist for subnational taxation. Against this empirical background, the most important theories of local and regional taxation are discussed and their applicability is examined. It is important to note that the aim of this unit is not to find the perfect and unique solution to the challenges in fiscal coordination or subnational taxation. Such a solution is likely to be non-existent. Optimal local and regional taxation always depends on many factors exogenous to fiscal policy, e.g. the political system, population dynamics or historical factors. Instead, the aim of this unit is to give a critical introduction to the many perspectives existent in the literature and to get students thinking about an aspect of fiscal policy very much dominated by expert discourse but of direct importance for every citizen.

Learning goals:

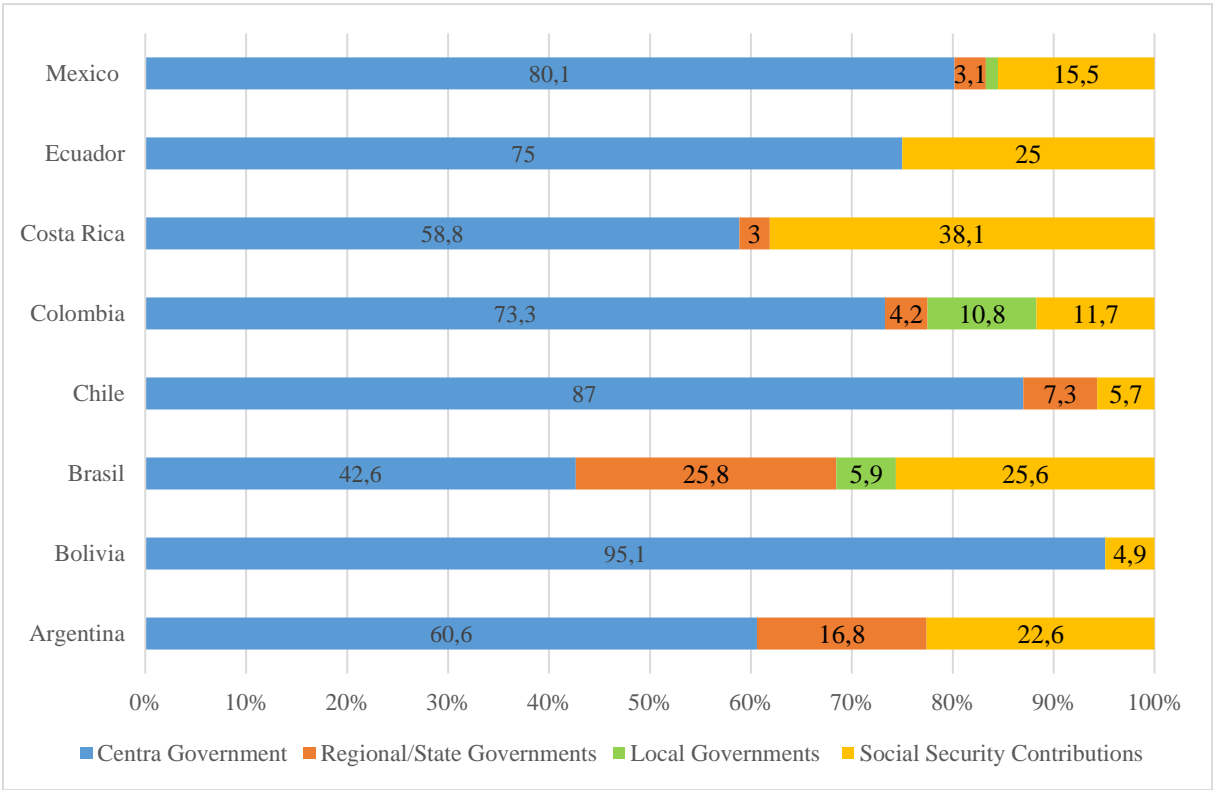
- Students will become familiar with positive theories of local and regional taxation, tax coordination, and theories of fiscal federalism.
- Students will know the importance and the challenges to local and regional taxation and fiscal coordination among national subunits.
- Students will learn which factors (economic, political, social) influence local taxation and fiscal coordination.

11.1 Subnational taxation in contemporary Latin America

Latin American states underwent some important decentralization processes since the return to democracy in the late 20th century. Different processes of political (local and regional authorities are elected directly), administrative (provision of public goods, rule making authority) and fiscal (tax authority or spending authority) decentralization have taken place and revalued the importance of local and regional political arenas for public policy. The outcomes of these decentralization processes were largely contingent upon the countries' historical determinants. Although similar reforms could be observed, Latin American countries differ in many ways with respect to decentralization. First, countries differ in the number of levels of government that exist and the constitutionally and legislatively mandated relationships among them. Second, local authorities differ in their degree of political decentralization and political legitimacy. Some have significant political power and are

popularly elected, while others are appointed councils that follow the directives of a more centralized level of government. Third, local authorities differ in their degree of autonomy in revenue-raising and expenditure decision making. In recent years, several authors have studied decentralization processes in Latin America, principally with the aim to find answers to the question why federal governments decentralize parts of their authority (O’Neil 2005) and what factors condition decentralization processes (Falleti 2010).

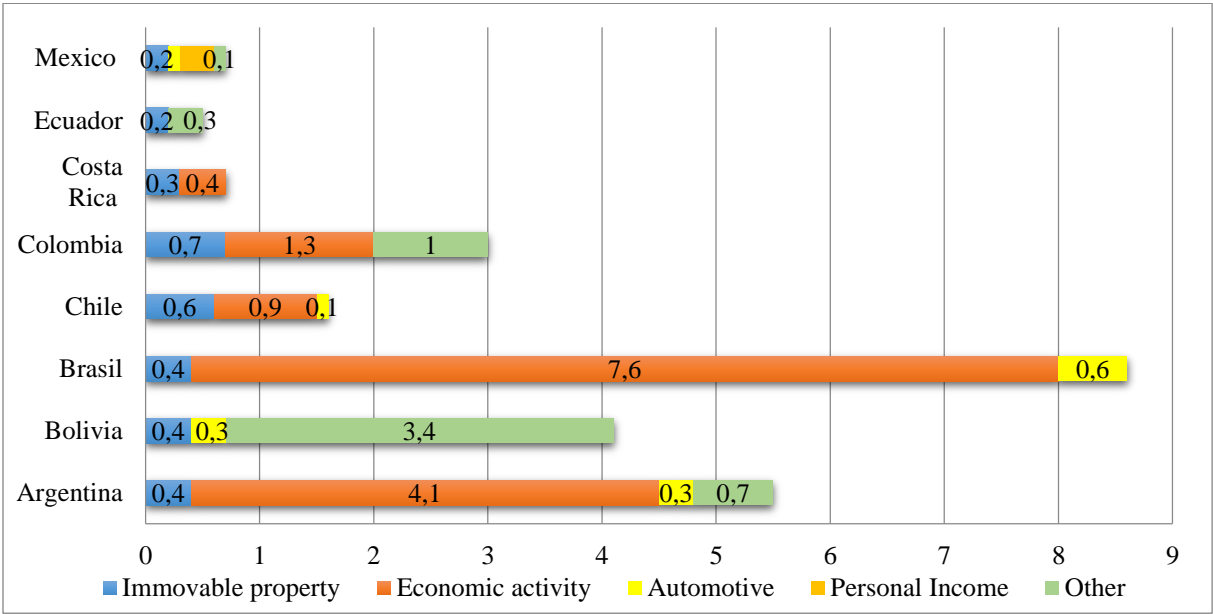
Figure 11.1: Tax revenues by level of government, 2013 (% of total)



Source: Own elaboration with data from OCDE/CEPAL/CIAT/BID (2016): <https://tinyurl.com/y86mur4u>

Although it is important to keep the first two dimensions in mind, we will focus on the latter, particularly on revenue raising (tax) authority. Figure 11.1 provides us with some actual data about the share of local and regional/state governments by level of government. We can clearly see that in countries with a long federal tradition such as Argentina and Brazil local and regional governments collect more taxes. An exception would be Mexico, which although federalist by constitution, is highly centralized in the revenue raising dimension. Quasi-federalist countries like Colombia and perhaps Bolivia have also made efforts to decentralize tax authority while some unitary countries like Chile and Ecuador remain highly centralized. However, for several reasons outlined above, decentralization of tax authority is challenging and in most countries, subnational governments still struggle to take full advantage of the tax bases assigned to them. In most countries, other non-tax sources of income (fees, royalties, contributions, etc.) make up the major part of local and regional/state budgets.

Figure 11.2 Subnational tax revenue structure in Latin America, 2014 (% GDP)



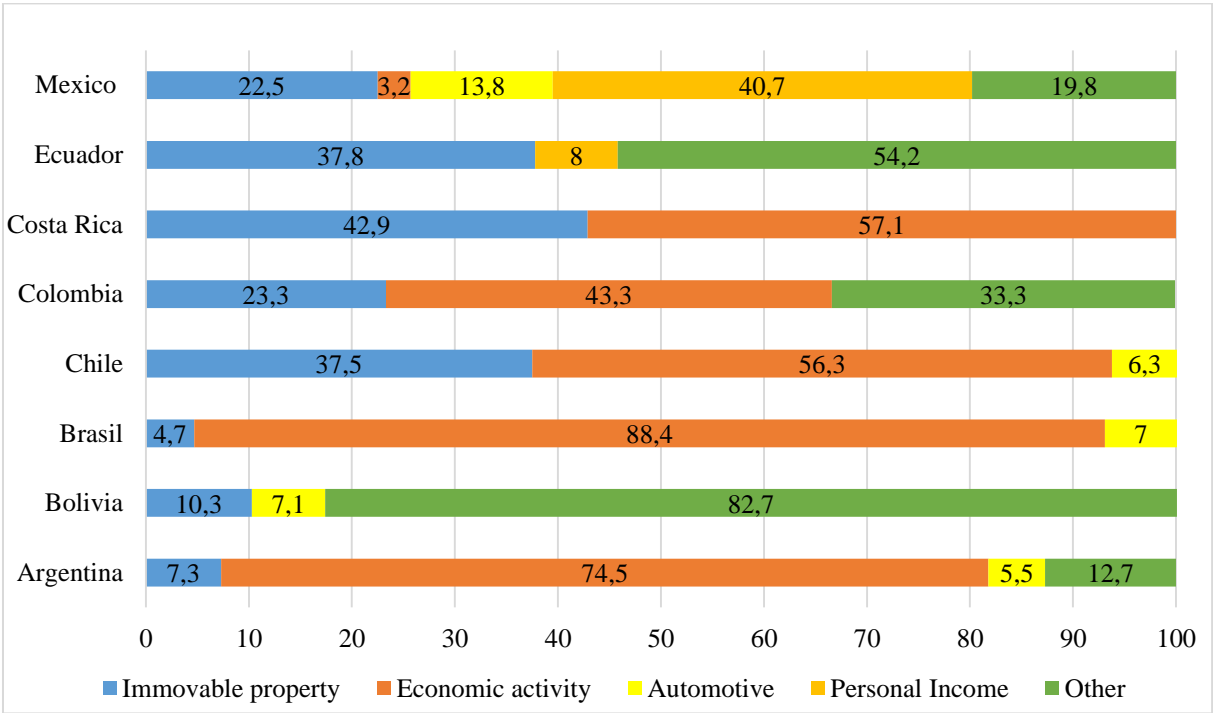
Source: Own elaboration with data from ECLAC, Economic Commission for Latin America and the Caribbean; Ecuador and Bolivia with data from 2013

Latin American countries not only show differences in the amount of tax revenue collected but also in the type of revenues they collect (tax revenue structure). Figure 11.2 shows these differences by two measures (as share of total subnational tax revenues and as share of GDP). Subnational governments in Argentina and Brazil can take advantage of their authority to collect taxes on economic activity (in Brazil the famous state VAT and in Argentina, a tax on *ingresos brutos*). Income taxes are marginal; Note also that local or regional authorities are responsible for collecting taxes on immobile property in all cases but which only ends up contributing marginally to revenue raised. In sum, important differences between the countries can be observed with some decentralized outliers (Argentina, Brazil) and some quasi-federal cases (Colombia, Bolivia) catching up.

In most countries, the degree of revenue raising authority stands in contrast to the expenditure authorities of local and regional governments. Today local and regional authorities in Latin America are partly or totally responsible for diverse public policies such as social infrastructure, (primary) education, environment or health (for more information about spending authority see e.g. Sabaini et. al 2017 or IMF data). In order to fill this gap between revenue and expenditure, local and regional authorities are largely dependent on federal transfers. Federal transfer systems tend to be complex and often entail a mix of unconditional automatic (free to use transfers) or conditional (bound to a specific spending item) transfers. Transfers generally aim to share the (federal) revenue collected by tax or non-tax means and distribute this revenue in accordance with different criteria (based on effort, equalization, most needed, etc.). Economic scholars have labelled this aspect of public finance “fiscal federalism”, i.e. the system of how tax and spending authority and revenue sharing is organized among several jurisdictional levels. Although federalism is in the name, this

phenomena is not limited to federalist countries only but may include quasi-unitary or even supranational (like the EU) political regimes. Connected with classic public finance contributions and modern political economy, this research area has developed some assumption and theories summarized below.

Figure 11.3 Subnational tax revenue structure in Latin America, 2014 (% of total subnational tax revenue)



Source: Own elaboration with data from ECLAC, Economic Commission for Latin America and the Caribbean; Ecuador and Bolivia with data from 2013

11.2 Local public finance theory and fiscal decentralization

In general, the fiscal federalism literature can be divided into two camps: an early normative perspective and subsequent empirical positivist works. Although mostly not addressing it explicitly, normative literature is largely in favor of an increase in subnational authority (in specific areas), while the current empirical contributions highlight the adverse effects and challenges of (forms of) decentralization or a specific federal state design.

The early normative works praised a decentralized (federal) state as an “engine of prosperity”, because it increases “institutional congruence” in public service provision or helps to secure competition between subnational governments and thus “preserves markets”. Institutional congruence is claimed because it is assumed that a decentralized state is superior in the provision of public goods (Oates 1972, 1977). This provision is superior as the beneficiaries of such goods, decision makers and taxpayers are better matched and hence problems of aggregation are reduced. It is assumed that (subnational) policy decisions can be better adapted to local preferences and needs, finally making local or regional governments more

effective and efficient (Oates 1977). This argument is also known as the decentralization theorem (Oates 1972, 35).

The decentralization theorem, in its early form, was criticized for underestimating likely externalities (spillovers), for example a public hospital which attracts patients from other provinces or localities) or economies of scale in the provision of public goods. If strong inter-regional externalities – positively in the form of benefit spill overs, or negatively in the form of cost spill overs – between subnational units occur, an institutional incongruence between consumption and provision of the public good exists. This can promote free riding behavior of some subnational units at the expense of their neighboring jurisdictions, e.g. a province will not invest in public health because most citizens can use a hospital of the neighboring province. Moreover, due to the economy of scale effects of some public goods, for example national public goods like defence, should be provided by a centralized agency.

This is also a challenge to fiscal policy, very well described by the problem of fiscal equivalence. The principle of fiscal equivalence is fulfilled if every citizen (beneficiary) is connected to the costs and benefits of local expenditures. In other words, the group of beneficiaries is identical with the group of cost bearers, and decision makers. Fiscal equivalence is meant to prevent fiscal illusion and to strengthen fiscal transparency and sound fiscal policy. Fiscal illusion is a concept widely used in public choice and first introduced by the Italian economist Amilcare Puviani in 1903. It suggests that when government revenues are not completely transparent or are not fully perceived by taxpayers, then the cost of government is seen to be less expensive than it actually is.

The second justification for a decentralized state is based on the writings of Tiebout (1956). Theorizing about the beneficiaries' behaviour towards a decentralized public good provision, Tiebout argued that jurisdictions providing local public goods enter into a market-like competition to attract mobile households. Households like consumers can “vote with their feet” to choose the best jurisdiction - maximal public services for the minimal costs -, which in consequence will foster competition between subnational units. In the long run this will lead to an overall optimal provision of public goods. Although Tiebout's reasoning is based on several strong assumptions (full information, mobility, etc.), scholars of the “second generation of fiscal federalism” developed this idea further, incorporating incentives structures and the possible behavior of political decision makers in the concept of a market preserving federalism (Weingast 1995). Increasing competition of (at least partially) independent subnational governments is here a kind of “silver bullet”, making markets more competitive and efficient, reducing corruption, fostering allocation efficiency of public goods or even promoting good (local) governance (Qian and Weingast 1997; Weingast 2009).

Decentralizing policy authority (also some tax authority) is also supported by another argument connected with this literature. This is the belief that a market like federal setting fosters policy experimentation and innovation. Subnational governments are assumed to react better to local or regional needs and to adapt their policies accordingly. Assuming that subnational governments have the authority over policy issues, innovative subnational

“problem-solving” policies can emerge and spread via diffusion or adaptation towards other units or even the central state level.

Pro-decentralization arguments based on the idea of the virtue of competition, however have one principal blind spot: they cannot give a credible answer to the question of how competition is stabilized so that (1) competition among jurisdictional units does not become so severe that it undermines all potential economic gains and (2) the coercive authority of the national government is kept in check so that the "property rights" of subnational units are not repealed (Filippov, Ordeshook, and Shvetsova 2004, 21). With respect to tax policy the first problem has to do with tax competition between subnational units and a race to the bottom of tax rates (comparable to what was mentioned in Unit 8). The second problem may pose adverse incentives for subnational tax collectors if their authority is not guaranteed.

Contemporary empirical research is much more cautious about the positive claims for decentralized state, and especially in Latin America, not every decentralized policy was a success, especially tax and fiscal policy. In some cases of a high degree of fiscal and political decentralization, regional income disparities or the size of government and spending increased, corruption was stimulated or macroeconomic stability was threatened. In sum, this empirical literature shows that the political and economic effects of subnational (fiscal) authority are multidimensional and often contingent on a number of other factors and by no means always positive.

But besides these grand theories arguing for more or less decentralization of (fiscal) political authority, how should subnational taxation be best designed? The classic textbook advice would name several guidelines (Smoke 2014: 289-90, Bird 2011):

1. Efficiency: local taxes should be as neutral as possible in terms of their effect on economic behavior and distortions of economic decisions made by individuals and firms should be minimized (see Unit 1).
2. Congruence: benefits and costs of local taxes should be clear to those for whom services are to be provided (see the problem of fiscal congruence). In other words, ensuring correspondence between payments and benefits.
3. Equity: basic equity standards should be met (see the challenge to externalities), i.e. and a fair treatment among equals (horizontal) and across different groups (vertical) - in terms of income – should be assured (see Unit 1).
4. Capacity: subnational tax authorities should be capable of administering assigned taxes in order to minimize costs of administration and compliance. This includes administrative feasibility in terms of ensuring that the scale and complexity of administration is consistent with available capacity and affordable to the subnational government.
5. Adequacy: public revenue generation should cover subnational budgetary needs. Here experts advise to follow the “finance follows function” principle.
6. “Buoyancy: growing in proportion to the economy and expenditure needs” (Smoke 2014: 289-90).

7. Stability: tax revenues should be stable and large fluctuations in revenue should be avoided. Unstable revenues jeopardize local public service provision.
8. Autonomy: subnational governments should have the discretion to make independent decisions, in order to create a link between revenue generation and service delivery.
9. Political feasibility: local taxes should be in line with the local political reality, i.e. with the acceptance of a tax by local society.
10. Integration/consistency: “ensuring the logic of the full set of subnational revenues and consistency with the rest of the national fiscal system (e.g., limiting overlap with central taxes and revenue disincentives in transfer and lending mechanisms).” Smoke (2014: 289-90).

All of these points sound relatively straightforward. Given the high economic and social regional disparities, challenges to the quality of public service provision due to geographic and infrastructural circumstances (remote areas, etc.), political challenges and generally high economic volatility, the realization of these guidelines is rather complex. In order to visualize this complexity this unit can revise some challenges to local public finances.

11.3 Challenges to local finances in contemporary Latin America

1. Fiscal decentralization, public service provision and federal fiscal bargaining

Regarding public service provision, central governments naturally have national goals and may aim to establish interjurisdictional equity that justifies intergovernmental transfers and service standards. In contrast, the optimal criteria for assigning revenue sources to local authorities will generally differ from the perspectives of central and local governments. This is because each subnational politician responds to his/her subnational political base and is interested in being reelected. This is a natural and expected outcome of a federal system. However, two challenges occur in Latin America with respect to taxation. In the case of a mismatch between spending and revenue authority, voters may or may not be aware of the links between local- and regional-level tax policy and the outcome of broader reforms (Wibbels 2005).

Secondly, there will be a constant bargaining process between local, regional and national authorities and political actors on fiscal policy. However, as such bargaining frequently takes place in an informal setting in Latin America, e.g. on a personal level or within parties, the wider political context matters for fiscal policy outcome. Electoral systems and legislative design also matter and may yield suboptimal results. Take the example of low personal income taxation in the region, which is suboptimal for re-distribution via taxation. Some authors argue that this is the case because of overrepresentation of low populated provinces and typically conservative provinces or states in the congress. This is one example of how the political dynamics of actual situations make it difficult to apply textbook advice.

2. Low budget constraints and subnational fiscal free riding in the 1990s

Weak subnational budget constraints for subnational governments (state and provincial) were one of the highly disputed topics in the fiscal policy in Latin America in the 1990s (Dillinger

and Webb 1999; Fukasaku and Haussman 1998). Critics argued that the accumulated public debt which eventually led to major state defaults in Argentina and fiscal crisis in Brazil were partly due to the unsustainable spending policies and debt taking policies of subnational governments. The story behind this claim was that in both countries (in Brazil more than in Argentina) a high vertical fiscal imbalance in the fiscal federal system existed. While federal governments were largely responsible for tax collection, the greater part of the expenditure was decentralized. Subnational governments thus would increase expenditure (e.g. because of an increase in the subnational public sector with which subnational governments could secure political support) while hoping that the federal transfers, with which they financed the expenditure, would do the same. As they did not, subnational governments would turn to issuing debt, largely through (public) provincial or state banks, and securing these loans with guaranteed automatic transfers from the federal government. This behavior, as long it is not limited by national or provincial legislation (i.e. hard budget constraints) would cause subnational debt to rise to unsustainable levels, and in times of economic turmoil, subnational governments would eventually threaten to default. On many occasions, federal governments had no other option to either bail out subnational governments directly via ad-hoc transfers or via nationalizing public local banks – thus priming unsustainable fiscal behavior by subnational governments. These countries had run in what is known as a “common pool” problem (Weingast, Shepsle, and Johnsen 1981), in which subnational units fail to internalize real costs of spending and drive the federal government to costly bailouts because of the existence of soft budget constraints.

The most probable solution in both countries, as well as in Mexico and other countries was the establishment of hard budget constraints for subnational governments. Based on national law, subnational governments are prevented from unsustainable spending, e.g. by restricting debt taking or restricting current expenditure. In addition, federal fiscal or judicial institution was installed to solve conflicts between the federal and subnational levels. However, although the existential threat of state default may be prevented by these regulations the core problem of persisting high vertical fiscal imbalances is still a major issue in most Latin American federations and quasi-federations. This is highlighted by contemporary single episodes of fiscal conflicts between the federal government and single subnational jurisdictions, e.g. in contemporary Argentina.

More generally, there has also been criticism of hard budget constraints for subnational governments as they curtailing their ability to engage in counter-cyclical spending in crisis times. In the case of Latin America such counter-counter-cyclical spending proved to be positive in some circumstances, for example in the wake of the global economic crisis in 2008 (Ter-Minassian and Jiménez 2011).

3. Horizontal fiscal imbalances and revenue allocation from natural resources

An important aspect of Latin American subnational finances is the imbalances of revenue effort generated between state or local jurisdictional units within the same country. These imbalances, frequently described as asymmetries in the horizontal fiscal (federal) distribution, or horizontal fiscal imbalances, can be found in every Latin American country. Frequently,

these imbalances reflect long term economic patterns of these countries (allocation of industrial clusters, cities, location of headquarters, etc.) but may also have to do with the location of extractive industries. As we know from Unit 10, revenues from non-renewable natural resources (oil, gas or minerals) are an important revenue source in many countries in the region, but the extraction of natural resources frequently takes place in remote areas, with significant social and environmental costs, as the fiscal regimes applied to extractive industries also regulate that local and state governments where the exploitation of these resources takes place will benefit from extraction. In addition, in many countries a part of these non-tax revenues is distributed via mechanisms of transfers to other jurisdictional units. In addition, subnational governments are also financed by duties, fees, etc. that can be counted as non-tax revenues.

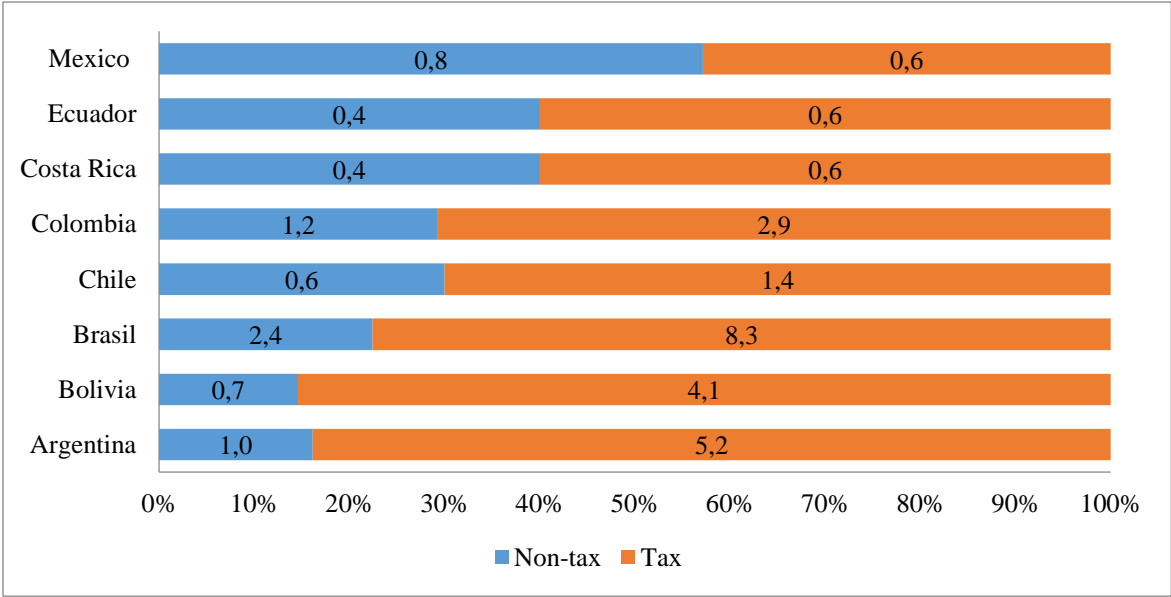
This is the cause of the importance of non-tax revenues for subnational finances in Latin America as stated in Figure 11.4. The figure shows that in some countries like Costa Rica, Ecuador, or Mexico, 40% or more of revenue is allocated according to this concept. In other countries, Brazil, Colombia, or Chile, this figure is still at 25% or more. In any case this shows not only the weak tax collection effort by subnational governments but also their need of additional financing as well as the effects of windfall profits via extractive industries. In general, the result of these circumstances is that horizontal fiscal imbalances are very high.

This confronts these countries with the challenge to implement effective mechanisms of cross-regional or cross-local revenue distribution. On the one hand, they have to use these resources to provide collective (nation-wide) public goods and thus engage in a kind of redistribution or centralization of these revenues. On the other hand, local and regional jurisdictions will call for revenues to compensate for natural resource extraction, not only because of the social and environmental costs that go hand in hand with extraction. Finally, as natural resource revenues are not endless, fiscal regimes ideally should also result in investments in the future, e.g. in stabilization funds, expenditure in technological progress or education.

This is why many countries in the region apply not only different fiscal mechanisms for the taxation of extractive industries (see Unit 10), but they also have established complex transfer mechanisms by which several of these goals ought to be accomplished.

However, research on rent distribution has found that several of these transfer mechanisms, increase corruption, foster unsustainable fiscal mismanagement, overstrain the spending capacity of local governments or are designed to fulfill political or partisan purposes. Although the distributional systems of resource revenues partly tend to equilibrate territorial disparities between producing and non-producing regions or localities, frequently the political, normative or legal aspects are more important than technical aspects (environment, economic or social). Finally, resource rents are spent right away and are rarely used for long term sustainable purposes (stabilization funds, etc.).

Figure 11.4 Tax and non-tax revenues of subnational governments in Latin America, 2013 (% of total subnational revenue, % of GDP)



Source: Own elaboration with data form ECLAC, Economic Commission for Latin America and the Caribbean

4. Subnational tax competition and externalities

Public choice theorists emphasize that competition can lead to a disciplining effect on local government’s tax policy and hence foster overall welfare as it keeps the “leviathan” (i.e. the government) small and effective (Brennan and Buchanan 1980). However, tax competition between subnational units can also lead to sub-optimal provision of public goods (Oates 1972:72). The basic problem of subnational tax competition is its interconnectedness: the selection of a tax rate by one unit will directly affect other units. Higher capital taxation in one unit will lead to a capital outflow to another unit. Thus, subnational governments may not select tax rates based on their financing needs but with respect to compete with other units. This can lead to an under-provision of local public goods, as individual and collective rationality are falling apart (Wilson 1986; Zodrow and Mieszkowski 1986).

Tax competition in Latin America is a less important issue than in North America or Europe. This is principally due to the lack of tax authority of subnational governments in the region. In Brazil, however, tax competition between state governments can occur and was part of a concern in the 1990s, as Brazilian states as well as municipality have the right to levy taxes. Brazilian states do collect a kind of sales tax (state VAT) next to the federal sales tax (federal VAT) next to other property or inheritance tax. A race to the bottom due to tax competition of Brazilian states, however, has not appeared but the Brazilian tax system is said to be increasingly complex, with multi-leveled legislation, recurrent legal conflict between jurisdictions, and multiple tax exemptions at various levels of government and thus less efficient.

5. *Local property taxation and re-distribution*

In Unit 2 we already encountered the argument for the fragile tax regimes and low redistributive impact of taxation in the region is the historically low progressive taxation of property, wealth and high income at the local level. In this argument, this was related to the type of colonization of Latin America and the then established pattern of social discrimination and inequality. One may not stick to this argument, but looking at property and wealth taxation in Latin America in a comparative perspective a pattern of low redistributive effort via taxation becomes visible. Revenue effort from taxes on immobile capital, i.e. property on land, houses, etc. is comparatively low. In Latin America, as figure 11.2 shows, tax revenue from immobile property tax do not surpass 0.7% of GDP (in Colombia). In international comparison, for example with the OECD average where property tax allocates to about 1.9% of GDP in 2014 - with countries like France or the UK collecting more than 3.7% of GDP – this is very low. Given that most Latin American countries are prone to high levels of inequality in landownership, wealth and property these numbers are even more striking. While technical or administrative reasons are frequently blamed for these shortcomings (lack of updated cadaster, low professionalism of local financial authorities, etc.) there are also political and social dynamics responsible. For example, in the case of Mexico until recently local authorities were only elected for three years providing no incentives for recently elected authorities to seek conflict with organized interests in reforming property taxation which then would pay out in future years after they have left office.

Group work – Case Studies:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if more groups than countries, groups can select other Latin American countries). The task for each group is to present a review of the current situation of a) local taxation and b) the transfer system in the country in question. What are the most salient challenges to this system and which explanations have been put forward to explain the current characteristics of the system? The group should present the ‘report’ before the class and show possible solutions.

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Unit 12: Wrap Up & Transfer: Taxation & Sustainability in the Andean Region

Rather than a classical wrap up of the previous sessions, this unit proposes a final group work exercise in which the relationship between taxation and sustainable development from an interdisciplinary social science perspective is explored and applied to the Andean countries. Such group work has several advantages:

- There are still very few scholarly works that explicitly explore the relationship between taxation and sustainable development. Although there is a historical concern about the fiscal sustainability of Latin American countries and the role taxation plays to reach such fiscal sustainability (balanced budgets, etc.), few studies explore the role taxation can play for other dimensions of sustainability. Such a limited focus is also present in research on the issue of “green” or environmental taxes – taxes which eventually aim to limit the pollution or contamination of the environment –that is at present principally limited to discussions on climate change. In sum, there is ample room to explore the nexus between sustainable development and taxation at an empirical and theoretical level.
- Such an exercise may also help to internalize the multidimensional perspective on taxation outlined in this course. As we have set out from the beginning, tax dynamics may be a symptom as well as a cause of social change. With this dual perspective on taxation at hand, students can explore which characteristics of tax systems and tax indicators may help to evaluate the progress towards sustainable development. In addition, students can explore the effects taxation may have on the multiple dimensions of sustainable development. For example, which role do tax systems play for social or political sustainability apart from the challenge to adapt tax systems to increase revenue collection.
- Based on the previous group work exercises in Unit 3, 4 and 6 to 11, students have gained a considerable understanding of the characteristics of the tax regimes in the Andean countries. This empirical knowledge can help them to connect their knowledge on sustainable development learnt during the master course with the multiple dimensions of taxation.
- This exercise enables a comprehensive revision of the previous sessions and enables students to apply and practice their knowledge gained in the previous units via a concrete task and outcome.

How can we connect what we have learnt in the previous session about taxation with sustainable development? A first step could be to define what is meant by sustainable development and to distinguish between social, economic, fiscal, environmental or political sustainability and to define concrete phenomena which challenge sustainability in these dimensions, like inequality, environmental damage, etc.. To all of these aspects, tax research can make a contribution based on discussion in the previous sessions and a connection between taxation and sustainable development can be drawn. This final unit offers a possibility to explore this nexus.

Group exercise:

Divide the class in n groups of n students. Each group should have a minimum of 2 and a maximum of 5 students. Each group should select an Andean country of its choice (if more groups than countries, groups can select other Latin American countries); preferably the country selection follows the previous group exercises. The task for each group is to choose an aspect of sustainable development, e.g. social, economic, fiscal, environmental or political sustainability. Based on this selection the group should discuss which concrete problems are existent in the country of interest in this aspect of sustainability (inequality, education, participation, accountability, contamination, etc.). The group should then elaborate, based on the material in the previous sessions, how these challenges are connected to taxation. In particular, the groups should respond to two questions: what characteristics and tax and public finance indicators improve our understanding of these challenges and why? What effect has the tax regime in the country on these challenges to sustainability in the country and why? The groups should prepare a short presentation for the class on these topics and discuss their work with their peers.

Literature:

This is a wrap up unit and thus the literature of the previous units is also relevant. Lectures may also use literature on sustainable development presented in the related master classes. Finally, the following titles may be of interest.

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About trAndeS

trAndeS is a structured postgraduate program based at the Pontificia Universidad Católica del Perú (PUCP) that contributes to sustainable development in the Andean region through its research and training activities. The project partners are Freie Universität Berlin and Pontificia Universidad Católica del Perú (PUCP).

trAndeS is financed by the German Academic Exchange Service (Deutscher Akademischer Austauschdienst, DAAD) with funding from the German Federal Ministry for Economic Cooperation and Development (Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung, BMZ).

The objective of **trAndeS** is to create and promote knowledge that can contribute to the achievement of the United Nations Agenda 2030 with its 17 Sustainable Development Goals (SDG) in the Andean Region. It focuses its efforts on identifying how the persistent social inequalities in the region present challenges to achieving SDG targets and how progress toward these targets can contribute to the reduction of these inequalities.

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With financial support from the



Federal Ministry
for Economic Cooperation
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