Social Contracts, Fiscal Pacts and Tax Reform in Latin America[1]

(For the Inter-American Development Bank)

By

Aaron Schneider, Victor Lledo and Mick Moore

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Contents

1. Introduction

It is a commonplace observation that, perhaps more than in any other part of the world, development and progress in Latin America has long been impeded by the apparent weakness of what many Europeans would term *social solidarity.* Different observers describe and diagnose this phenomenon in many different ways, but most attribute real significance to the adverse consequences of: large inequalities of wealth, income, power and effective citizenship; weak senses of identification with or concern for a common, national good; continuing resistance to the resolution of difficult national issues through the democratic process; and the apparent prevalence of narrow and particularistic concerns in the political process. One could look at patterns of taxation in Latin America and find in them clear reflections of this weak sense of social solidarity. Most concretely, taking into account income levels and other relevant factors, Latin Americans pay less tax than one would expect on the basis of comparisons with other regions of the world (IDB, 1998). There appears to be widespread tax evasion, especially on the part of the wealthy, who can take advantage of their transnational connections to shift income off-shore. The processes of making and changing tax policy are not very transparent. They seem to be dominated by interest groups, which frequently aim to create legislative and administrative loopholes that they can then exploit. Tax bases are unduly narrow, and income taxes in particular are ineffectively collected. It is hard to find citizens who believe either that the procedures for tax collection are fair, or that the taxes they pay represent equitable and reasonable contributions to a larger purpose and social entity with which they positively identify.

In this chapter, we focus on ways of thinking about the relationship between taxation and society that might help Latin Americans resolve some of these problems. More precisely, we argue here that it is useful, for both analytic and for practical policy purposes, to think about taxation in Latin America in terms of a *social contract*. That social contract currently is weak in most of the region: compared to some other parts of the world, there is no very strong notion that citizenship revolves in part around obligations to make financial contributions to the state and fellow citizens, and around the associated rights to representation in the taxation and public expenditure processes. The suggestion that such social contracts might begin to shape politics and governance in the region is not wishful thinking. This is already beginning to happen, especially around political negotiations either to re-establish democracy or to nurture weak democracies in the face of stress. Latin Americans are increasingly talking about *fiscal pacts*: negotiations between organized societal and political interests around substantial, consensual changes on both sides of the fiscal ledger and in the nature of governance – taxes, patterns of public expenditure, and mechanisms of representation and rights. These kinds of negotiations, whether or not formally described as fiscal pacts, can be seen as conscious attempts to construct a (fiscal) social contract.

We are in favor of fiscal pacts. Their usefulness may not depend only on whether or not they result in clear agreements, and whether those agreements are always respected. Also important is the fact the debates around these pacts help place the big socio-political issues about fiscal policy on the public agenda. Lack of transparency is both a symptom and cause of the (politically) dysfunctional nature of much fiscal policymaking in contemporary Latin America. Taxation and expenditure decisions are both highly fragmented and unduly influenced by particular interests. There is no ‘big debate’, but an endless sequence of ‘little deals’. The very notion that government and opposition, capital and labor, big business and small enterprise, or peasants and workers collectively should try to negotiate these issues is a progressive step. Viewed from this perspective, fiscal pacts are complementary with another major fiscal innovation now being pioneered in Latin America – participatory budgeting. Both are ways of subjecting fiscal policy to more open and transparent public debate.

There are three main sections to this chapter. In Section 2 we explore a set of tax policy reforms that have been implemented in Latin America since the 1980s at the instance, largely, of the international financial institutions. We label these the *Washington Consensus* reforms. They have involved above all the simplification of tax structures and the removal of exemptions and special privileges; the replacement of trade taxes by value-added taxes (VAT); and an emphasis on improved tax administration. Although not fully implemented, these reforms have generally been useful. To some degree, they have helped pave the way, both politically and administratively, for the kinds of debates and agreements that we have labeled *fiscal pacts*. However, these reforms have come at a price: other issues have been driven and kept off the tax policy agenda. The excluded issues comprise, above all, considerations of equity and an explicit concern for governance questions - the interactions between tax policy and the legitimacy of governments and the policies they pursue.

We explain in Section 3 that, in a rather quieter way, many Latin American governments recently have initiated a series of 'indigenous' tax reforms. These owe little to the support or urging of international financial institutions, are designed to deal with particular local problems, begin to address some of the more important political dimensions of tax reform, and have been modestly successful. These indigenous reforms provide a basis on which Latin American countries could build more wide-ranging programs of tax reform tailored to regional and national circumstances.

In Section 4 we argue in general for more focus on the political and governance dimensions of taxation. More explicitly, we suggest that the kinds of bargaining that have taken place in some Latin American countries under the label of *fiscal pacts* represent positive steps forward and realistic routes to the construction of effective national *social contracts* around issues of public revenue and expenditure.

2. The *Washington Consensus* reforms

In the sphere of taxation, as in fiscal issues more generally, there is a substantial history of attempts to promote coordinated reforms on a region-wide basis in Latin America. One example was the Joint Tax Program launched by the Organization of American States (OAS), the Inter-American Development Bank (IDB), and the Economic Commission for Latin America (ECLAC) in the early 1960s. This involved, among other things, conferences on tax administration and fiscal policy, and a draft, model tax code for Latin America (Joint Tax Program, OAS, IDB and ECLAC 1965a, 1965b). The focus was on tax policy rather than tax administration, and the tax policy elements were shaped by prevalent beliefs in "the superiority of direct taxes to indirect taxes, support for progressivity, and opposition to assignment or earmarking of tax revenue ...." (Goode, 1993, p.38).

In contrast, the *Washington Consensus* tax reforms, initiated in the 1980s and continued through the 1990s, gave a great deal of attention to tax administration and shifted the substantive burden toward indirect taxes levied on domestic sources. These reforms have aimed to (a) make the tax structure more neutral and less distortionary; (b) simplify revenue operations, legally and administratively; (c) increase levels of revenue collection, notably to deal with problems of (hyper-)inflation; and (d) promote what in the jargon is termed the 'horizontal' dimension of equity in tax systems rather than the 'vertical' dimension.[2] More concretely, the tax reforms promoted and adopted in the in the region since the 1980s have been shaped by the following operational principles:

(i) The replacement of taxes on foreign trade and cascading turnover taxes with broad-based and uniform value-added taxes.
(ii) The reduction of the highest statutory tax rates and the simplification of personal income tax systems.
(iii) The reduction or elimination of preferential treatment for particular sources of corporate income and particular economic sectors.
(iv) The modernization and strengthening of the institutions involved in tax administration.

(v) The use of withholding taxes, current or advance payment systems, and adjustments for inflation, tax credits and debits in order to moderate the erosive effect of inflation on the actual value of tax revenue.

In addition, and especially in the 1990s, more attention had been paid to harmonization of taxation around international norms as a means of promoting intra-regional and international economic integration.

In summary, over the last two decades, reforms have focused on: improving administration; macroeconomic management concerns; and making tax structures simpler, more neutral, and better suited to international economic integration (Tanzi and Zee, 2000). Issues of distributive equity and industrial policy have mostly been left to other policy instruments. Were these reforms successful? This will remain a matter of controversy. For two reasons in particular, it is difficult to make comprehensive overall judgments.

One reason is that the reforms have been implemented rather inconsistently. Measures to improve tax administration appear to have received the greatest attention. Most governments have begun to use banks as tax collection agents, and virtually all tax collection authorities have been re-organized around *functions* (e.g. collection, inspection, control, large taxpayer units) instead of around individual taxes (IDB, 1997; Vilela, 2002). Other administrative measures include staff training, improving career structures, introducing modern information technology, and revising procedures. Several governments have accepted the advice to establish more independent tax administrations, generically known as *autonomous revenue authorities* (Taliercio, 2004).

In relation to tax policy itself, reforms directly supported by international financial institutions achieved most between 1989 and 1994, when there were reductions in international trade taxes and in high marginal individual and corporate income tax rates (Lora and Panizza 2002). Other reform proposals, particularly those geared towards streamlining tax regimes, eliminating exemptions, or broadening the tax base, were implemented less consistently, reversed, or watered down. Some commentators have identified a 'drift' in tax reform since the mid-1990s (Shome, 1999; Vilela, 2002). For example, although marginal tax rates on high incomes were reduced, attempts to widen tax bases were blocked. In addition, existing turnover taxes were left in place after the introduction of value-added taxes, as many governments worried more about securing revenues than about the distortions created by inefficient tax systems. Some levies, such as presumptive income taxes, were introduced but later abandoned. They were moderate revenue raisers, but met opposition and were overturned largely as a result of pressure from foreign investors. Finally, even where income tax bases were broadened in principle, they were often crammed full of exemptions by powerful interests.[3]

A second source of dispute about the success of the *Washington Consensus* reforms derives from the use of different criteria to assess results. Some researchers conclude that the reforms are associated with economic growth and stability. Escaith and Morley (2001) found that tax reforms had a positive and significant impact on economic growth in a sample of 17 Latin American countries. Similarly, the IDB calculated a 0.2 percentage point increase in annual rates of economic growth in reforming countries; a 15 percent reduction in the volatility of the fiscal deficit; and a slight improvement in income distribution (IDB, 1997). Using different criteria, Behrman et al. (2000) and Morley (2000) concluded that the reforms widened wage inequality to a dangerous degree. Marginal tax rates were lowered for higher income groups and businesses while value-added taxes hit poorer consumers. In several cases, tax exemptions for basic goods were eliminated, and punitive taxes on luxury consumption were lowered. Further, they suggest, trade protection and special incentives for industries and activities previously had been effective in creating jobs. When they were removed, people who depended on wage labor suffered.

There are also concerns about the governance dimensions of the *Washington Consensus* tax reforms. They were conceived and designed largely by tax specialists who attempted, with some success, to redefine taxation as a specialist technical subject. These specialists dealt with governance issues only tangentially, mostly by redefining administration as a dimension of tax policy.[4] Insofar as they had an implicit governance concern, it was to de-politicize tax policy. The administrative reforms brought undeniable benefits, but they were not in any explicit sense designed to address the issues of (weak) political legitimacy or social solidarity with which we are concerned here. However, we note one positive governance dimension of these *Washington Consensus* reforms. Insofar as they have either succeeded in simplifying tax systems or at least helped make the case for greater simplicity, they have increased the scope for the kind of open public debate around taxation that comprises the essence of fiscal pacts and (fiscal) social contracts. It is very hard to engage in informed debate about fiscal issues if the taxation system is complex and full of exemptions and special cases. Less informed actors find it difficult to identify where their interests – or those of other actors – actually lie. And the more informed parties benefit from keeping their information to themselves. As we shall see in Section 4, there is evidence to back the logical proposition that simplified fiscal regimes are conducive to society-wide bargaining.

3. Indigenous tax reforms

The international financial institutions have been influential in promoting what they view as 'market-conforming' tax reforms in Latin America. They have however not been totally dominant. Unlike in some other parts of the global South, Latin American governments have exhibited considerable capacity to initiate, design and implement tax reforms that tackle problems that seem pressing. Unlike the *Washington Consensus* reforms, these indigenous reforms are not shaped around a common, coherent body of principles. They reflect rather a set of more pragmatic reactions to domestic circumstances. However, they do to some degree address some of the deeper structural and institutional problems faced by Latin America that did not significantly influence the *Washington Consensus* reforms, notably: (a) vast structural inequality and a related inability or unwillingness to exploit traditional forms of direct taxation such as those on income and property, (b) the administrative difficulties of taxing a large informal sector, (c) highly inflationary environments, (d) strong pressure for additional tax revenues for fiscal adjustment purposes, and (e) weak social contracts and institutions of governance. We summarize these 'indigenous reforms' here, dealing separately with tax policy and fiscal institutions.

In the area of tax policy, there are five sets of 'indigenous' reforms that merit attention here: (a) the taxation of gross assets, (b) simplified taxation schemes levied on small firms, (c) the taxation of land value improvements (land value capture), (d) the taxation of bank account transactions, and (e) the (implicit) taxation of foreign capital inflows.

Gross asset taxes

Inflationary environments alter the values of current and future profits and liabilities and make it especially easy for firms legally to avoid taxes through accounting practices and adjusting the use of various debt and equity instruments. The gross asset tax allows governments to reclaim some of these missing revenues. “There have been two basic reasons for the introduction of this tax in Latin America: first, the need for additional revenue in countries undergoing major adjustment programs; second, the realization that traditional taxes on the income of enterprises do not fare well in situations of substantial inflation” (Sadka and Tanzi, 1992: 1).

A critical element in the design of gross asset tax is the choice of tax base and the method used in its valuation.[5] The gross asset tax is generally imposed on a taxpayer’s gross business assets, both current and long-term. Current assets may include cash, securities and inventories, while long-term assets comprise mostly land, property and other fixed assets. The 'gross' denomination stems for the inclusion of debt-financed assets in the tax base – in contrast to net asset taxes, that are levied only on equity financed assets. This 'gross' base has proved appropriate to an inflationary environment that would otherwise permit companies to convert real positive profits into reported losses that decrease current and future tax liabilities.

The advantages of a tax on gross assets go beyond their administrative effectiveness in tackling tax avoidance in inflationary environments. Sadka and Tanzi argue that gross assets may be a better proxy of the *normal* or *average* income flow generated by an individual or firm than the actual income reported yearly for tax purposes (Sadka and Tanzi, 1992: 9). In addition, gross asset taxes encourage owners of capital to use it productively, and may consequently be more efficient than standard forms of capital or corporate taxation that create disincentives to work and save and generate deadweight losses. There is even a possibility of using gross asset taxes to pursue progressive goals if it provides exemptions for minimum levels of assets and/or small firms.

Revenue from standard taxes on capital or net worth declined substantially in many Latin American countries during the 1990s. Correspondingly, support for gross asset taxes grew. They proved particularly successful in Mexico (Shome, 1999). The Mexican tax base included all types of corporate assets, adjusted for inflation, and allowed no deduction for debt. This base was taxed at a rate of 2 percent, was allowable against the corporate income tax (minimum income tax), and exempted financial institutions and small taxpayers (Thirsk, 1997: 318). Other countries that introduced similar taxes include Argentina, Costa Rica, Guatemala and Venezuela (Tanzi, 2000).

The decision to implement gross asset taxes is affected on several factors. Governments have to decide if they are to replace or complement minimum income taxes and taxes on income from capital. This decision should depend in part on the effectiveness of these other taxes. The current emphasis on international economic integration within the region and with industrialized countries raises additional considerations. International tax agreements are required if gross asset taxes are to be accepted as a final tax on actual income, and correspondingly become eligible for tax credits against tax obligations in other countries.

Taxation of small firms

The number of small firms, especially those in the informal sector, has increased exponentially in Latin America. They are important sources of employment and income for poor citizens, very diverse, but poorly integrated in the tax system. Integration is important for the viability of any social contract around taxation. Efforts have been made in several countries to achieve this integration by levying simplified, presumptive taxes on small firms. These taxes are (a) are levied on gross corporate revenues and (b) substitute either for VAT or corporate/personal income tax. They reduce compliance costs for small firms. For revenue authorities, they diminish costs of assessment, monitoring and collection, which have usually been large relative to the revenue actually raised from small firms. Costa Rica, Dominican Republic, Guatemala, Mexico, Nicaragua, and Paraguay have implemented presumptive taxes for small taxpayers.

In taxing small firms, Argentina, Bolivia, Brazil and Peru have replaced several of the major levies (VAT, income, and social security taxes) with a *single tax* (Tanzi, 2000). Brazil introduced a single gross revenue tax for small firms in 1996 (*Simples*). Argentina did the same in 1998 (*Monotributo*). Brazil's Internal Revenue Service tracked a group of small enterprises which were active in 1996 and which in 1997 opted for the *Simples* (Brazil, Secretariat of Federal Revenues, 2000). Initial estimates revealed a reduction in 90 million Reals in the costs involved in receiving and processing their tax files. The same set of firms has created 500,000 new jobs – perhaps most importantly, these are now in the formal sector.

Land value capture

The extremely unequal distribution of property in Latin America has always made both ownership and taxation contentious. In many countries, land taxes go unreported and uncollected in an implicit agreement between rulers and ruled. All too often, the largest and most powerful landowners, rural and urban, pay the least tax. Reopening this politically divisive issue requires care. One way in which governments are renegotiating their bargain with those who own property is by linking tax contributions to direct benefits accruing to property owners as a result of state action. *Land value capture* taxes link tax obligations explicitly to the benefits received from public investments that increase the value of land. New roads and bridges, for example, will normally increase the capital and rental values of nearby properties. Owners can be asked to return part of the increased value to the public purse.

The land value capture tax (recuperacion de plusvalias in Spanish) goes back to the 1920s in countries such as Brazil and Colombia (Smolka and Furtado, 2002). Debate about it centers on the taxation of urban property. Large Latin American cities such as Sao Paulo, Santiago and Bogota have started to introduce land value capture mechanisms or strengthen those already nominally in place (Smolka and Furtado, 2001). In the city of Mexicali, capital of the Mexican state of Baja California, the traditional property tax, based on the combined value of land and buildings, was replaced by a tax exclusively on land value (Perlo, 1999).

The growing popularity of land value capture in Latin America has less to do with its long-recognized efficiency and equity properties than with the increasing fiscal and political pressures for revenue mobilization at the local level. Fiscal and administrative decentralization has given urban administrations more spending responsibilities, and democratization has increased the demands directed to them. As a result, they have looked for revenue sources beyond historically ineffective property taxes (Smolka and Furtado, 2002).

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

Taxation of bank account transactions

Administrative weakness and distorted economic activity complicated the construction of a social contract around tax, in part by starving the state of resources with which to purchase public support. Bank debit taxes sought to confront these factors simultaneously.

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

The tax was introduced in several cases with explicit ties to social spending and/or fiscal adjustment (Coelho et al 2001: 9). In Brazil, for example, the tax was approved at first on a temporary basis to secure revenues for social policy and was later renewed to aid in fiscal adjustment efforts.

The tax secures some political support for its apparently progressive incidence. Those without bank accounts are unlikely to feel the burden of the tax, and those who use their bank account more pay the most. Full incidence studies have not been conducted, however, and it is unclear whether the tax results in higher prices for basic goods purchased in transactions-intensive retailing outlets. The political utility of a progressive appearance is undeniable, however, and the tax has passed in several countries.

The tax also has advantages from an administrative standpoint. Given the consolidated and satisfactory role of banks as collection agents, the tax is easy to collect (Tanzi 2000). In addition, the tax captures revenues from sectors that lie outside the net of traditional income and sales tax bases. For example, the informal sector may escape most tax efforts, but it eventually makes some contribution as a percentage of bank activity. In addition, tax evaders that under-declare income or sales end up contributing in their bank contributions. In addition, astute tax administrations can detect potential evaders where large sums of money move through banks that have not been reported in income. Such advantages have led to enthusiastic endorsement by some Latin American tax administration officials (Brazil, Secretariat of Federal Revenue 2001).

BDTs have been particularly productive for revenues in Brazil, Colombia and Ecuador (around 1 percent of GDP). In the remaining Latin American countries, the tax take has been smaller. Such taxes were originally introduced in Argentina (1983, 1988 and 2001), and also implemented in Peru (1989), Brazil (1994 and 1997), Venezuela (1994 and 1998), Colombia (1998), and Ecuador (1999).

The political attractiveness of using BDTs as temporary tools receives technical support from those who are sceptical about their long-term effects. BDTs may be related to increased interest rates that ultimately offset the revenue contributions of the BDTs (Albuquerque 2002). Further, some remain extremely doubtful about the microeconomic efficiency of BDTs. Such taxes have a cumulative and cascading nature and can lead to disincentives to use the banking system. Banking systems that already have limited coverage may become increasingly disarticulated over time and have damaging effects on the long run stock of capital (Tanzi 2000, Coelho et al 2001, Albuquerque 2002).

Short-term Capital Controls

One important economic interest group with which Latin American governments have to deal has no formal role in national policymaking. International capital drives most Latin American economies, yet most governments lack the ability to control and manage capital flows, which are notoriously fickle. Between June 1991 to September 1998, the Central Bank of Chile implemented a series of controls on the short-term movement of financial capital. These took the form of an unremunerated reserve requirement (URR), obliging capital importers to make a deposit with the Central Bank proportionate to the size of the inflow. The deposits were to be held for approximately a year, and a penalty was charged if capital was exported before a given period of time. This URR is equivalent to a tax that declined over time with the permanence or maturity of the capital inflow. The tax nature of the device was even more explicit if foreign investors took the option to pay the Central Bank an up-front fee based on the relevant foreign interest rate and the fraction of capital subject to the restriction. This deposit requirement gave the government greater capacity to balance its external and internal accounts in an environment of limited exchange-rate flexibility. The tax would offset the appreciation of currency required for a sustainable current account while keeping the interest rate differential in line with a sustainable government fiscal situation (Nadal-De Simone and Sorsa, 1999).

Several recent papers have attempted to evaluate the effectiveness of Chile's capital controls. There is evidence that the URR (a) led to higher domestic interest rates - or at least a larger differential between local and international interest rates; (b) provided an incentive for tax avoidance and evasion; (c) altered the composition of inflows in favor of medium or long-term capital; and (d) reduced the overall volume of transborder capital flows in ways that eased macroeconomic management (Gallego, Hernadez and Schmidt-Hebbel 2002; Le Fort and Sanhueza, 1997).

The URR mechanism has limited revenue impacts. Its benefits mostly lie in reducing vulnerability to economic crisis and creating incentives for longer-term investment. It is clear from the Chilean case that these benefits can only be realized if the government or central bank is active in combating avoidance and evasion and able to prevent corrupt collusion on the part of its own staff.

In sum, the recent Latin American indigenous tax innovations sketched out above respond directly to a range of technical, structural, and political realities specific to the region. They also begin to address some of the correlates and causes of the weakness of the state-citizen contract in relation to fiscal matters. It is to these governance issues that we now turn.

4. Fiscal Social Contracts

The term *social contract* is a metaphor. No such contract was ever signed in a literal sense. It is however far from an empty concept. There is real substance to the notion that some societies and polities are formed by implicit agreements between governors and governed about what each can expect from the other, both substantively and in terms of the procedures of governance. And such implicit agreements are relatively visible and concrete when they are forged around fiscal issues. There is a lively body of literature that traces the creation of *effective* states in Western Europe to implicit *fiscal contracts*, in which rulers secured predictable, bargained tax revenues from organized tax-paying groups in return for giving those groups formal political representation and substantial influence over fiscal policy in particular, and public policy generally.[6] We emphasize the word 'effective'. Polities that cannot resolve basic issues about resourcing the public sector in a consensual fashion are deeply handicapped.

Let us not set up the idea of a social contract around taxation as (yet another) hurdle over which Latin American countries must leap before they can become developed. It is not a target to be attained, but rather a direction in which to steer. Latin America will approach nearer a social contract the more that:

(a) The ways in which governments raise their financial resources, and the use they make of them, are considered matters of legitimate concern for citizens; and major issues are decided through the democratic process.

(b) The purpose of taxation is to fund collective national projects and interests, rather than the state apparatus itself.

(c) Tax-raising agencies treat taxpayers as citizens, and follow due process in assessing and collecting taxes.

(d) Arguments about the capacity of different taxpayers to contribute play an important role is determining tax liabilities.
(e) A positive normative value is attached to meeting tax obligations.

The social contract is weak in much of Latin America because its history is different from that of Western Europe. There is a stubborn legacy of conquest, inequality, militarized and exclusive governance, and political violence. As we saw in the introduction to this chapter, there is plenty of evidence of the feebleness of any notion of a (fiscal) social contract in the attitudes and behavior of many contemporary Latin Americans. But there are also grounds for hope that these attitudes can change. We look here at differing, but positive, recent experiences in Brazil and Chile.

Participatory Budgeting Institutions[7]

The first example of an expanding social contract is drawn from the local level in Brazil. A new, local fiscal pact emerged in Porto Alegre as a result of negotiations within participatory budget institutions. These institutions bring citizens to open, public assemblies to discuss the public budget. The meetings begin long before the legislative budget cycle, and occur in regional and thematic meetings. Participants select investment priorities and elect delegates who continue to meet throughout the year to negotiate the final budget document. To allocate investments, planning officials use the priorities decided by the community in a formula that weights the neediest neighborhoods. These plans are incorporated into the budget and then passed through the legislature and implemented during the fiscal year.

The taxation side of participatory budgeting has been little studied, although fiscal capacity has been acknowledged as a central component in making participation attractive. In the early 1990s, participatory budgeting meetings served as a site for government to explain municipal accounts to citizens and secure support for tax reforms that could finance new spending. To secure popular support, government promised to use new resources for investments decided in the meetings. In particular, the government secured support for progressive taxes in meetings that disproportionately mobilized poor neighborhoods (Marquetti 2000). As a result, the city adopted a progressive rate structure for the property tax and instituted a service tax that exempted housing, health, and cultural services. These two major taxes, adjustments to fees and inflation indexes, and increased vigilance over tax evasion collectively boosted municipal revenue. The city recovered its fiscal balance, freed over 10% of the budget for investments, and reduced its dependence on fiscal transfers from higher levels of government.

The tax reforms that emerged in the early years of participatory budgeting were watered down and rolled back over time, but the experience of pacted fiscal reform remained. Participatory meetings had created a space for the government to negotiate fiscal adjustment with society, and, for a time, provided popular support for increased and more progressive taxes. These institutions mobilized social groups around a progressive taxation agenda that connected tax increases to public investment projects that had legitimacy because they had been selected in a popular and participatory fashion. This legitimacy and popular support helped to overcome legislative and political opposition.

Chile's Tax Reform

A more explicit example of tax reform in the context of a (national) fiscal pact is provided by the experience of Chile in 1990, when an elected government took power after 17 years of military rule.

Substantively, the reform comprised four major elements: corporate income tax was increased from 10 to 15%; the standard VAT rate was raised from 16% to 18%; marginal personal income tax rates were increased for taxpayers in intermediate income brackets; and various tax exemptions for the private sector were eliminated. Most observers characterize the reforms as either neutral or regressive in their impact on income distribution. These were not the actions of a radically progressive government eager to transfer income to poorer populations at any cost. Yet the net effect was redistributive: as had been clearly agreed by the various parties to this pact, the enhanced tax revenues were used to increase social spending.

At least two factors specific to the recent history of Chile helped create the conditions that made this kind of pact possible. One was that there was a widespread notion that there was indeed a 'social debt' to the poor, arising from their previous experience under the military regime, that should now be paid. The other was that the tax increases could be represented as a dimension of restoring the country to normality: the military regime had cut the government's tax take by 5% of GDP between 1980 and 1990.

However, there are three other broad dimensions of the process surrounding the Chilean fiscal pact that are more generally relevant to other Latin American countries. They encourage us to believe that similar kinds of pacts are possible elsewhere, and throw light on the conditions under which this might be possible:

First, and in contrast to the typical situation in most Latin American countries in recent decades, the 'fiscal environment' was supportive in two senses. The taxation system was relatively clear and simple because the military government had to a large degree adopted the *Washington Consensus* taxation principles. Debate did not become too mired down in ambiguities about apparent and actual tax obligations. The different interests could engage with one another in a relatively straightforward way. Further, inflation had been kept low. There was little danger that any agreements reached in one year would be undermined or obscured by rapid and uneven price changes. Highly inflationary conditions are rarely conducive to the kind of fiscal debate that was conducted in Chile in 1990.

Second, the negotiation process was carefully managed. The pact was explicitly agreed to be valid only for four years. No party was committed forever. And the Minister of Finance signaled a strong commitment to linking the taxation and the expenditure dimensions of the pact by making it clear that, although the earmarking of specific revenues for specific purposes was legally prohibited, the new social expenditures would be made only when the new tax revenues began to flow into the public treasury.

Third, this was a pact very much in the Latin American corporatist tradition, in that it was the result of extended negotiations between various organized groups both inside the legislature and outside it. The governing five-party coalition, "La Concertacion", included most of the political spectrum from Left to Center. In addition, the coalition sought and secured the support of an important moderate Right-wing party that often voted with the opposition. For the government and the moderate Right, a super-majority coalition was both necessary and convenient. The government needed support to legitimate the reform in the Lower House of the legislature, and to pass the reform over the objections of far-Right senators in the Upper House. These senators had been appointed for life by the outgoing dictator. Involvement in a multi-party pact ensured that the moderate Right-wing party could limit the extent of the reforms and claim some of the credit for increased social spending. More generally, in the context of a new democratic regime, most political parties wanted to be associated with a momentous new agreement on fiscal policy. But the pact also engaged other actors outside the political party system. The technical team that designed the reforms included respected professors from the University of Chile who enjoyed legitimacy with many social sectors. They spent a year in discussions with major social actors about the reforms. The main business association, the Production and Commerce Confederation (CPC) was also closely involved. Without their agreement, the government had little hope of securing parliamentary support, and cutting down on tax evasion would be more difficult. The CPC agreed in part because the reforms were moderate, largely neutral, and aimed for revenue totals that remained below 1980 levels.

5. Conclusion

The kinds of fiscal pact that was achieved and implemented in Chile – but never fully agreed or yet implemented in the far more tense political environment of Guatemala – hold promise as a way of moving toward broader social contracts in Latin America. A variety of political and other factors will shape what is possible in each case. However, there are three general reasons to be optimistic about the potential for fiscal pacts in the region.

First, tax (and public expenditure) regimes that have been simplified and standardized in accordance with the *Washington Consensus* principles are more transparent, and therefore provide a more secure basis on which political parties and social groups can negotiate. They can operate with some confidence that (a) they understand what is going on, and (b) it should be possible to monitor any agreements that are reached.

Second, the (quasi-)conquest of inflation in Latin America – allied to the partial indexation of many tax rates to inflation – should have a similar effect. High levels of inflation can render any fiscal understanding or agreement largely void.

Third, Latin America has a tradition, manifested again in many recent transitions to democracy, of national negotiations between potentially antagonistic groups that achieve some kind of resolution. The encouraging recent experiences of 'indigenous' tax reforms that extend well beyond the precepts of the Washington Consensus lead us to believe that some countries at least have the internal political, institutional and technical resources to design and obtain social agreement on tax reforms that would help pay off the large 'social debt' that has accumulated in the region.

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[1] The material on tax reform in this paper is presented at more length in Lledo, Schneider and Moore (2004). Oriol Mirosa-Canal and Marina Navarro-Mangado provided assistance.

[2] In essence, while 'vertical equity' considerations approximate to classic concerns about redistribution from rich to poor, the notion of 'horizontal equity' addresses the concern that activities should not be discouraged by differential tax rates: butchers should be taxed in the same way as bakers, and software engineers as salesmen. The notion of 'horizontal equity' embodies a strong preference for non-interventionist economic (and tax) policies.

[3] Shome (1999) estimated that, throughout the Latin American region, personal tax exemptions increased from 1.29% of GDP in 1991 to 1.36% in 1997

[4] It was in this context that Bird and Casanegra (1992) wrote that in "developing countries tax administration is tax policy".

[5] See Sadka (1991) for a description of the opportunities for avoidance created by inflationary environments and Krelove and Stotsky (1995) for a succinct exposition of issues around the design of asset taxes.

[6] For a general statement of the case, see Tilly (1975, 1992); for a critique see Moore (2004, forthcoming).

[7] This discussion is a summary of Schneider and Goldfrank (2002). Also see Avritzer and Navarro (2003); Santos (1998); and Abers (2000).