CENTRE FOR THE FUTURE STATE

IDS
Institute of Development Studies
Sussex

Research Summary #5 - Governance, Taxes and Tax Reform in Latin America

By Aaron Schneider, Victor Lledo and Mick Moore (2004)

This paper forms part of a five year research programme under the Centre for the Future State, based at the Institute of Development Studies. Below is a summary of principal findings. Further details are available at www.ids.ac.uk/gdr/cfs/index.html

Introduction

This paper reviews the experience of tax reform in Latin America in the 1980s and 1990s, and considers the implications for governance and poverty reduction. The reforms were initiated as part of broader 'Washington Consensus' measures, and involved simplification of tax structures, replacement of trade taxes with revenue from value added tax (VAT), and improved tax administration. Although not fully implemented, the reforms were generally useful. But the focus on technical and administrative measures, which helped the reforms to gain acceptance, came at the expense of neglecting equity and governance dimensions. A series of low key, indigenous reforms have started to address more political aspects of tax reform: they provide a basis for future reforms which might start the process of building a national social contract around public revenue and expenditure issues.

The Latin American Context: Tax and a Social Contract

The paper looks at political institutions and social and economic structures that have affected tax, and the tax relationship between states and citizens in Latin America. Although there are significant differences between countries, common features include a low average tax take compared to other regions; under-taxation of wealth and property; heavy dependence on indirect trade taxes; and multiple rates and high levels of exemption for direct taxes. High income inequality, a large informal sector, and a large share of agriculture in total GDP all contribute to the difficulty of collecting direct tax. Military regimes have tended to adopt regressive tax policies; democratic governments have found it hard to resist pressure for spending from important constituencies. All of this helps to explain the lack of a social contract based on state-society bargaining around tax. There are few explicit links in public debate between taxes paid and benefits received. Indirect taxes have been largely invisible to ordinary citizens. At local level, reliance on block grant funding has broken the link between tax and spending. Multiple exemptions have encouraged evasion, and bargaining around special interests (rather than broader mobilisation of taxpayers). High inflation, which quickly erodes any gains negotiated, has been a further deterrent to taxpayer organisation.

Tax Reforms: Rationale and Impact

The approach to tax reform in Latin America, led by the International Financial Institutions (IFIs), has focused on improving administration; on macro-economic management and enhancement of revenue; and on making tax structures simpler, more neutral and better suited to international economic integration. Equity issues, and the importance of tax for political development, have been largely neglected. Reforms have not been implemented consistently. Political opposition blocked some reforms, and lack of administrative capacity made others impossible. Measures to eliminate exemptions and to broaden the tax base have been reversed or watered down: for example, reductions in high marginal rates of income tax were implemented, but not accompanied by a broadening of the tax base. Reforms in tax administration have been implemented more consistently, and also reductions in taxes on foreign trade. There are different views about the impact of reforms: some associate them with economic growth and stability; others argue that they have widened wage inequality and that value added tax (VAT) is hitting consumption in regressive ways.

Indigenous Tax Reforms

In addition to reforms led by the IFIs, Latin American governments also initiated 'home grown' measures to address particular local problems which were more politically sensitive. These included innovative policy reforms to explore presumptive methods of taxation on income; taxation of financial transactions; alternative ways of taxing property (including land value capture); and environmental taxes. There were also institutional reforms including participatory budgeting arrangements (notably in Brazil), and new revenue sharing arrangements between central and local levels of government (which have been problematic, not least for macroeconomic management). These reforms have been low key and modestly successful; they could provide the basis for more wide-ranging reforms tailored to regional and national circumstances.

Conclusions

The paper suggests that tax reform has the potential to help address the vicious cycle of high social, economic and political inequality; radical disagreement over political institutions; and the consequent difficulty of getting wide consensus over how to deal with economic problems and crises. The tax relationship is central to the construction of an (implicit) social contract. Many of the groups benefiting from the current set-up would also potentially benefit from taxation systems that were more transparent and equitable, provided more resources to address poverty, and commanded wider public legitimacy. The challenge is to stimulate debate in a constructive fashion. There are two positive features which might support such debate: (1) widespread recognition in government circles that taxation issues need to be addressed, with reform already underway; and (2) capacity and willingness in the region to experiment with a range of new tax practices that may be better adapted to the needs and circumstances of the region then those initiated by the IFIs.

The paper concludes by listing the challenges facing Latin American tax systems in the next few years. These are: (1) increasing direct taxation; (2) improving the administration of VAT; (3) re-evaluating the assignment of tax bases and tax revenues among government levels; (4) re-examining the distributive effects of the tax system; (5) relying more on tax policy to address informal activities and environmental damage; (6) adjusting tax policy and administration to the economic integration process without compromising efficiency and equity; (7) tying tax policy to citizen benefits, especially pro-poor expenditures and representation; and (8) improving political institutions in ways that broaden and deepen social contracts.