Taxation in Latin America: Reflections on Sustainability and the Balance between Equity and Efficiency

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Abstract

My aim in this paper is simply to explore in an admittedly discursive and preliminary fashion some aspects of the complex balancing act needed to achieve economically and politically sustainable tax systems in Latin America. By a “sustainable” tax system I mean one that is sufficiently congruent with prevailing economic and political factors in a country to persist without the need for repeated major “reforms”. Specifically, my thesis is that one key to achieving a sustainable tax system is to strike the right “balance” between the equity and efficiency aspects of taxation in terms of the equilibrium of political forces.

Experience suggests that any state that wishes to both grow and to implement redistributive fiscal policies – whether the aim be much or little redistribution -- must first establish an administrable and efficient tax system. At the same time, however, to make such a system politically sustainable, it must be considered “fair” by a majority of the politically relevant population. Essentially, I suggest in these preliminary musings on this complex subject that one reason why many countries in Latin America do not appear to have either an efficient or a fair tax system is essentially because of the very limited scope of this segment of the population, so that the politically relevant “domain” of the fiscal system is considerably smaller than the population as a whole.

Some specific suggestions are made in the paper with respect to how both the efficiency and the equity outcomes of Latin American tax systems might be improved. My general conclusion, however, is the perhaps somewhat pessimistic one that a more democratic and sustainable outcome cannot, as it were, be induced by better fiscal institutions. On the contrary, a more encompassing and legitimate state is itself the key ingredient needed for a more balanced and sustainable tax system. Countries with similar economic characteristics in similar economic situations can and do have and sustain very different tax levels and structures, reflecting their different political situations. In a variant of a phrase currently popular in the literature of political economics, when it comes to tax matters, in general “politics rule.”
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Taxation in Latin America: Reflections on Sustainability and the Balance between Equity and Efficiency

Richard M. Bird

1. Introduction

Tax policy is always and everywhere a balancing act. Thousands of papers and dozens of textbooks have been written on how best to achieve the balance between efficiency and equity in tax design. In reality, however, when it comes to making actual tax policy decisions, administrative and especially political factors not only have to be taken into the balance but also almost invariably end up dominating both equity and efficiency. In addition, as the recent “globalization” discussion has emphasized, international as well as domestic factors need to be balanced in determining tax policy.

My aim in this paper is simply to explore a few aspects of the complex balancing act needed to achieve economically and politically sustainable tax systems in Latin America. To avoid possible confusion, I should perhaps note at once that I generally use “sustainability” in this paper to refer to a much broader concept than common in economic discourse, where the term is largely linked to e.g. attaining fiscal balance in the sense of maintaining a target debt-income ratio. What I mean here by a “sustainable” tax system is one that is sufficiently congruent with prevailing economic and political factors in a country to persist without major reform. In particular, as the title of the paper indicates, I am concerned with achieving a sustainable “balance” between the equity and efficiency aspects of taxation.

To launch the discussion of this broad topic, in Section 2 I review a few salient facts about taxation in Latin America over the last few decades. In Section 3 I then place these facts in the broader context of changing ideas about the appropriate role of the tax system, not only in Latin America but more broadly. In the next three sections of the paper I consider, in turn, what fiscal economists think we know about the efficiency aspects and costs of taxation (Section 4), about equity and fairness in taxation (Section 5), and about some aspects of the political economy of taxation (Section 6).

Given the complexity of each of these subjects, the treatment here is obviously not only condensed and general but also inevitably superficial in some respects. The idea, however, is simply to place on the table what appear to be the main factors that should, and to some extent do, influence views on the appropriate role of taxation in

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1 An early version of part of this paper was presented at a conference in honor of Arnold Harberger held at UCLA on Feb. 14-15, 2003. Some other portions draw on (unpublished) joint work with Eric Zolt (for the World Bank) and with William Fox and Michael McIntyre (for the United Nations). I am also grateful for comments on the first draft from Jorge Martinez-Vazquez, Guillermo Perry, Michael Walton, and Eric Zolt.
dealing with the pervasive reality of continued, and even increasing, inequality in Latin America.²

In the balance of the paper I turn to some issues more specifically related to taxation and inequality in Latin America. To begin with, in Section 7 I first ask the deceptively simple question “Who pays the taxes?” and argue that, although we do not, and cannot, have a clear answer to this question, this uncertainty, perhaps surprisingly, does not matter much from a tax policy perspective. In Section 8, I then ask “How can we untax the poor?” and suggest a few policies that can readily be adopted to achieve this objective -- if countries really want to do so.³ In Section 9, I turn to the other side of the equity question and ask “How can we tax the rich?” Again, I argue that, within limits, it is not all that hard to do so – if a country really wants to do so.⁴

Finally, in Section 10 I restate the dominance of politics, emphasizing that how a country decides its tax policy is generally more important in shaping its tax system than exactly what it decides at any particular time. As a coda, I note in Section 11 that while “globalization” has likely made life a bit more difficult for would-be tax policy reformers in Latin America, it has not made it impossible. If a country in Latin America or elsewhere wants to have a tax system that is both more efficient and more equitable, it can -- within limits of course – generally have one, no matter what the WTO, the IMF, and world capital markets may appear to demand.

2. Tax Trends in Latin America

Latin American countries face a difficult task in achieving a sustainable policy balance in the face of the often conflicting and frequently changing forces, external and internal, economic and political, that most of them have faced in recent years. Both the facts that should govern policy and the fashions that too often do govern it have changed markedly over the last few decades in most countries in the region. It is thus not surprising that tax policy has also changed -- though not, as we shall see, all that much either in level or in structure.

Generally speaking, those countries that had relatively high taxes at the end of the 1970s were still above the regional average in the 1990s, just as those that depended more on income than on consumption taxes continued on the whole to do so. To take two small examples, in 1980-82 Guatemala’s tax ratio (taxes as a percent of GDP) was 9.8%, of which only 2.8% came from personal income taxes; in 1995-99, the comparable figures were 8.9% and 2.2%. At the other extreme, although Nicaragua’s tax ratio rose from

² I do not discuss here the extent and pervasiveness of this inequality, which is well-documented in IDB (1998) as well as Gasparini (2003) and other materials prepared for the forthcoming World Bank report on Inequality and the State in Latin America.
³ Of course, as discussed at length in IDB (1998), the main way governments can and should attack poverty is through spending, not tax, policies, a point to which I shall return briefly later.
⁴ Note, however, that as Engel, Galetovic, and Raddatz (1999) and Harberger (2003) emphasize, even quite effective taxation of the rich, while it may be both economically and politically desirable, is most unlikely to have much impact on income inequality. This point too will be discussed further later.
23.6% in 1981-83 to 26.2% in 1995-99, the share of taxes on domestic consumption remained dominant, although declining a bit from 49% to 46%. Of course, tax rates in these countries did not necessarily change in the same way as tax ratios: for example, the VAT rate in Nicaragua rose from 6% to 15% over this period.

Table 1

<table>
<thead>
<tr>
<th>Country</th>
<th>Early 1980s</th>
<th>Early 1990s</th>
<th>Late 1990s</th>
<th>Early 1980s</th>
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<td>1.2</td>
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<td>5.9</td>
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<tr>
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<td>16.8</td>
<td>4.0 (3.1)</td>
<td>4.6 (2.6)</td>
<td>3.6 (3.4)</td>
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</tbody>
</table>

Sources and Notes: Based on GFS data from Tanzi (1987) and Stotsky and WoldeMariam (2002). Years covered vary slightly from country to country, but generally 1980-82, 1990-94, and 1995-99. Simple averages reported: numbers in parentheses exclude Venezuela, in which the income tax share is biased upwards by oil revenue. “Income tax” includes all taxes classified as such in GFS (personal, corporate, withholding).
Table 1 summarizes a few key quantitative facts about taxation in Latin America, for the 13 countries for which all data are available for the period. To begin with, consider the case of Central America a bit further. The countries of this region, although small, are surprisingly diverse. They have in common, however, both poverty and a high degree of inequality. They have also all in recent years adjusted to adverse economic situations largely through expenditure cuts, including some that have adversely affected the poor, rather than through tax changes (Corbacho and Davoodi, 2002).

As Stotsky and WoldeMariam (2002) discuss in detail, the general trends in taxation in Central America are similar to those elsewhere in the LAC region over the last decade. Although revenues from income taxes have remained a fairly constant share of total taxes, which actually rose slightly as share of GDP, enterprise (or corporate) income tax (EIT or CIT) rates have on the whole been cut, as have those of the personal income tax (PIT). In contrast, in part as a result of trade liberalization, taxes on international trade have fallen significantly, with the loss being made up largely by domestic consumption taxes, and especially the value-added tax (VAT).

Table 2 summarizes the changes in major tax rates over roughly the same period. As elsewhere in the world (see the OECD figures in Table 2, which exclude Mexico, the only OECD country in Latin America), both personal and corporate tax rates were cut sharply in recent years in most countries. At the same time, VAT rates rose in a number of countries (from an unweighted average of 12.1% in 1994 to 14.7% in 2001). Bolivia and Colombia have flat rate PITs, at very different rates; Uruguay has no PIT, except for a small tax on agricultural income and commission income;6 all other countries shown in the table have graduated rates.

Not only have income tax rates fallen, but the scope of the system has been altered considerably, from one which, on average, began to impose tax in the mid-1980s at a taxable income level of about 60% of per capita GDP to one that cuts in at a level 2.3 times per capita GDP. At the same time, however, the average level at which the top bracket takes effect has declined sharply from 121 times per capita GDP to only 20.7 times GDP. As IDB (1998) shows, there are very great differences in all these respects from country to country. For example, in Chile the minimum taxable income is only 15% of average per capita income, while in Guatemala it is almost 12 times per capita income, and the level of the top bracket ranges from 119 times per capita income in Honduras to less than twice per capita income in Chile and Barbados.

Finally, although not shown in Table 2, it is perhaps worth mentioning that Latin America is rather unusual in the number of countries that impose some form of tax on corporate net worth or assets, with at least 13 countries having such a tax in 2001, although in several cases the tax is imposed only on real estate and in other cases it is levied in the form of a minimum tax that may be credited against normal corporate taxes. Although this tax yields little revenue and appears to be widely evaded, it nonetheless in

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6 Paraguay and Bahamas (not included in Table 2) also have no PIT.
Table 2  
Rates of Major Taxes, 1986-2001

<table>
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<tr>
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Source and Notes: Stotsky and WoldeMariam (2002). Years shown are approximate in some cases. PIT rates are top marginal rate. Enterprise (EIT) rates are also top rate. VAT rate is “standard” rate. Averages are unweighted regional average. Uruguay has no PIT except on income from agriculture and commissions.
some cases constitutes an important component of the marginal effective tax rate imposed on new capital investment (Bird and Chen, 2000).

These data, partial and in many ways unsatisfactory as they are, suggest several interesting conclusions. First, over the last few decades taxes have not gone up in Latin America. Some rates have risen, mainly for VAT, but many have declined, mainly for income taxes. Tax collections as a share of national income have, on average, declined a bit. In this sense, the “capacity” of most countries to redistribute income through the fiscal system has not changed much. Moreover, in world terms, Latin American countries tend to be “below average” in terms of the size of their public sectors relative to their levels of per capita income (IDB, 1998).

In a recent analysis, Martinez-Vazquez (2001a) notes that one of the most striking features of the various major tax changes that have taken place in Mexico over the decades (e.g. Gil Diaz, 1990 and Gil-Diaz and Thirsk, 1997) has been how very little apparent effect they have had on Mexico’s tax ratio (taxes as percent of GDP), which has remained almost constant. He suggests several possible explanations for this constancy: the reforms in tax structure (1) may have been undermined by unrelated ad hoc measures, or (2) they may have been offset by administrative deterioration, or (3) one or both of the preceding may have occurred less by accident than by intention.

Similar relative constancy can be seen in other countries (e.g. Colombia) over the decades despite repeated tax “reforms.” While this phenomenon clearly requires more careful examination, such evidence perhaps suggests that a “good” tax reform – one intended to raise more revenue in a more efficient and equitable fashion, for instance -- may be something like a “good” seat belt law. That is, if everything else stayed the same, lives would be saved, but things don’t stay the same – some people drive faster when they are belted in, so death rates show little change. Similarly, as developed further later in this paper, it may perhaps be the case that countries tend to achieve an “equilibrium” position with respect to the size and nature of their fiscal systems reflecting largely the balance of political forces, and then stay there until “shocked” to a new equilibrium.

A second conclusion suggested by the data is that the importance of income taxes, usually – though by no means always correctly, as discussed later – seen as the “prime redistributor” of the tax system -- has not increased significantly either, despite the well-documented increase in income inequality over this period. Indeed, at first glance, at least for the countries included in Table 1, income taxes seem to have fallen slightly, from 22.3% to 21.4% of tax revenues, on average. Excluding the peculiar case of Venezuela (which collects much of its oil revenue in the form of income taxes), however, income taxes actually rose slightly, from 17.5% of total taxes in the early 1980s to 19.9% by the late 1990s, despite the marked declines in tax rates shown in Table 2.

These figures mean little from the perspective of income equality, however, because, in all cases for which data are available only a miniscule portion of income tax revenues comes from personal income taxes, the only tax that seems on the surface at least to be progressive – though even this is sometimes doubtful, as noted later. In the
1995-99 period, for example, only in Costa Rica and, surprisingly, Uruguay – which does not actually have a personal income tax! – did the PIT account for more than one percent of GDP, and the average PIT/GDP ratio for the eight countries for which information is available was only 0.6%. “Income taxes” like those in most Latin American countries which are collected primarily in the form of corporate income taxes are, as Harberger (2003) observes, more likely to end up taxing low-income workers and consumers than high-income profit recipients. (See Box 1 below.)

Thirdly, those countries that were most dependent on income taxes at the beginning of the period were, on the whole, still most dependent on this revenue source at the end. Indeed, for the most part the relative share of income taxes varied surprisingly little. In Chile, for example, at the beginning of the 1980s, income taxes provided 21.8% of taxes; 20 years later, the ratio was 21.6%. In Mexico, the comparable figure was constant at 34.9%. All five countries which received more than 20% of taxes from income taxes in the early 1980s also did so 20 years later. Colombia showed a particularly startling increase, with over 40% of all taxes from income taxation at the end of the period (although, it should be remembered, income taxes as a share of GDP actually fell in Colombia). Although the importance of income taxes went up slightly in such “low-income tax” countries as Uruguay and Nicaragua, these countries remained at the bottom of the pack in this respect.

As in the case of the apparent inertia of tax levels, this apparent constancy of tax structures requires more careful examination. At first glance, however, the data appear to lend further support to the hypothesis that the tax policy in place in any country at any time to a considerable extent reflects fundamental economic and especially political forces that change only slowly over time.

Still, despite the relative constancy in both tax levels and tax structures across and within countries, many changes have taken place in tax policy across this complex region over the last few decades. Economic and political circumstances have changed dramatically at times in some countries, and sometimes tax systems have changed with them, though not always as one might expect: the case of Nicaragua, discussed later, is an interesting example. The reality of taxation in Latin America has perhaps changed less than our perception of it. That perception has indeed changed considerably over the last half century and may well be in the process of changing again. Since perception tends to trump reality in the political arena, and no public policies are more political than taxation, changing ideas about taxation are discusses further in the next section.

3. Changing Ideas about Taxation

The View from 1960

In the 1950s and 1960s, tax policy discussion, and to a lesser extent tax reform, in Latin America largely reflected on the one hand the dirigiste and developmentalist views common in the post-war era – as exemplified, for example, in the work of CEPAL and
others influenced mainly by European experience and thought – and, on the other hand, the emerging “reformist” approach of the largely US-trained advisers and consultants unleashed on the continent by the Alliance for Progress and USAID.\textsuperscript{7}

To oversimplify considerably, while there were many differences between these approaches – and others, such as the well-publicized flying visits of Nicholas Kaldor to Chile, Guayana, and Mexico\textsuperscript{8} – most analysts at the time seem to have taken it for granted that a highly progressive personal income tax (sometimes with marginal rates ranging up to 60 or 70\%) buttressed by a substantial corporate income tax (often at 50\% or so) constituted something close to an “ideal” tax system. Consumption taxes – then mainly excises, customs duties and cascading manufacturers sales taxes -- were grudgingly accepted as necessary for revenue purposes, but the feeling one gets from reading most documents of the period is that the sooner such levies could be replaced by decent income taxes the better. No one talked about local taxes, since all the action was at the central government level. And finally, since no one seems to have worried much about the international context, tax policy was almost invariably considered to be a largely domestic affair.

The two main aims of taxation at the time were considered to be, first, to raise revenue – and lots of it -- in order to finance the state as the “engine of development” and, second, to redistribute income and wealth. Since then, as now, income and wealth were markedly unequally distributed in Latin America, the need for redressing the balance through fiscal means seemed obvious to all, and the ability of taxes to do the job was largely unquestioned. Indeed, both these goals – revenue and redistribution – could, it was generally thought, be achieved largely by imposing high effective tax rates on income, essentially because the depressing effects of taxes on investment and saving were considered to be small. Indeed, an extra bonus of high rates was sometimes argued to be that they made it easier to lead balky private investors by the very visible hand of well-designed fiscal incentives into those channels most needed for developmental purposes.

In short, to exaggerate only a bit, the conventional wisdom at the time was essentially that all developing countries needed to do to solve their fiscal problems was to “learn to tax” (Kaldor, 1963), which usually seems to have meant to tax in a properly progressive fashion.

\textit{Thirty Years Later}

Views on the appropriate role and structure of taxation began to change in the 1970s and 1980s. By 1990 or so, in contrast to the immediate post-war era, most economists and policy-makers thought that high tax rates not only discouraged and distorted economic activity but were largely ineffective in redistributing income and wealth. Reflecting this “new view,” income tax rates on both persons and corporations

\textsuperscript{7} For a review of this early period, see Bird and Oldman (1968). See also Bird (1992) for an update on experience in the 1980s and Shome (1999) on the 1990s.

\textsuperscript{8} See, for example, the reports reprinted in Kaldor (1980)
were cut sharply and are now almost universally in the 20-30% range in Latin America, as elsewhere in the world (Shome, 1999). On the other hand, reflecting – indeed, to some extent leading – world-wide trends, the VAT is now seen as the mainstay of the revenue system in Latin America (Ebrill et al. 2001). Moreover, the decline of taxes on international trade with liberalization and the WTO as well as increased competition for foreign investment have moved international concerns from the bottom to the top of the tax policy action list in many countries. At the same time, in many countries, a new issue has risen to prominence on the fiscal menu as decentralization made the question of setting up adequate sub-national tax systems an increasing concern, not least in Latin America (IDB, 1997). Even though all these changes do not as yet seem to have had a very marked an effect on the numbers cited earlier, life in the Latin American tax policy world is thus very different in many respects at the beginning of this century than it was in the middle of the last century.

Everywhere in the world, of course, economists have at best a mixed record in terms of their actual influence on tax policy. Economists who wish to influence public policy must pay close attention to the issues that motivate policy-makers, and communicate in ways that are understood by those who make the decisions. This is not a plea for “dumbing down” tax policy analysis. On the contrary, it is a plea to smarten it up. In particular, tax recommendations that assume that distributional considerations are either unimportant or can easily be accommodated by (unspecified) adjustments somewhere else simply do not resonate in the policy context of most countries. Distributional issues not only matter in tax policy but often dominate in the minds of those who shape that policy. The reluctance of most tax experts to discuss distributional issues too often relegates them, and their evidence, to the sidelines in tax policy discussion.

Quantitative studies of the distributional effect of taxation (such as those summarized in Chu, Davoodi, and Gupta, 2000) are decidedly out of academic fashion. This is understandable because, as discussed further in Section 6, such studies are both conceptually and empirically difficult and extremely assumption-sensitive, so that their results are not all that meaningful. Nonetheless, equity issues are at the heart of public economics, and unless and until economists can deal more explicitly and satisfactorily with the distributional question, their success record in influencing public policy seems unlikely to improve much.

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9 See also Burki and Perry (2000). Since my views on decentralization and subnational taxation are set out at some length in Bird (2001), this issue is not discussed in detail in the present paper.
10 See, for example, the review of this question in Canada by Bird and Smart (2001)
11 The relevant distributional concern may not be with the poor. To give a rather blatant example from the LAC region, in one country no progress could be made in income tax reform until advisers realized that the main concern of officials and ministers appeared to be with the impact any reform would have on them personally. Thereafter, care was always taken to highlight the relevant income groups in policy simulations!
12 As noted in Section 6, such studies also seldom very useful for tax reform. For an earlier review of distributional studies in Latin America, which notes also that the distributionally relevant categories for policy-makers are often regions, age groups, or occupational categories rather than simply income classes, see Bird and De Wulf (1973).
Tax policy is less about economics than politics. To understand how economic analyses of tax issues are likely to be perceived and hence to affect policy outcomes, one must thus understand something of the political economy of taxation. Scholars such as Persson and Tabellini (2000) have made major contributions to this field of study in recent years. But there is clearly much more that can and should be done to understand how the tax system existing in any country works, why it works that way, and how it might realistically be altered to improve policy outcomes. More attention needs to be paid to the problem of formulating tax policy in a democratic setting (Hettich and Winer, 1999) in light of the best scientific knowledge instead of leaving it, as now generally the case, to the shifting winds of political fashion.

For example, as noted earlier, if one wishes to affect policy, one must normally write in a way, and in a forum, that will come to the notice of policy-makers. In a democracy, if economists have the “truth” and the people have the “power”, then speaking truth to power means not whispering in the ear of a benevolent prince but rather engaging in public discussion of key policy issues and attempting to convince wider audiences of the cogency and importance of the economic analysis of taxation. While current academic mores may render such involvement difficult for those aspiring for tenure in academic departments of economics it is only through such efforts to communicate to policy-makers directly or indirectly and through engaging with the (small) informed public with which policy-makers interact that progress occurs.13

The public may not want to hear that there is no free lunch and may not agree with what economists say. Nonetheless, good policy analysis must focus on what can be done in real conditions. Moreover, it is surely incumbent on those who want to influence policy to communicate their findings to the public as clearly and effectively as possible so that the final policy judgment, whatever it may be in the end, is as well-informed as possible.

To illustrate these points, the downward pressure on personal and corporate income tax rates has certainly been supported, if not initiated, by increasing evidence of the distortions caused by high marginal tax rates (as discussed further in Section 4). Equally, the rapid adoption of the value-added tax around the world, while clearly largely revenue-driven (and often initiated by the IMF), in part at least rests on acceptance of the economic argument that this form of taxing consumption reduces economic distortions. On the other hand, equally convincing (or unconvincing) economic studies of the damage done by poorly-designed excise, property, and payroll taxes seldom seem to meet with a similarly receptive audience. It is thus hard to avoid the conclusion that the widespread adoption of lower income tax rates and of the VAT is probably more attributable to political economy considerations than to the advice of economists.14

13 To put this another way, as Harberger (1993) has argued, economists need to pay more attention to their role as policy practitioners if they are to play that role more effectively. Of course, some very deep waters are being skated over rather quickly here.
14 For an example, of a good modern approach to tax policy, see Box 1 – and compare its recommendations with the actual tax policy found in most countries.
To illustrate a “modern” approach to tax analysis and design, consider an unduly neglected paper by Arnold Harberger (1985). This brief paper begins with a discussion of the incidence and design of income taxes in small, open economies—a characterization that seems appropriate for many countries in Latin America and the Caribbean. Harberger argues that in a completely open economy, labor, being considerably less elastic in supply than capital, may often bear more than the burden of corporate income taxes. Nonetheless, he says, such taxes are essential both to enforce personal income taxes and to avoid transferring corporate taxes to the treasuries of others. Logically, given this view of the corporate income tax, he goes on to recommend that there should be full integration of corporate and personal income taxes. Moreover, since in such an economy taxes on personal capital income, like those on income earned through the corporate sector, will end up being paid by relatively less mobile workers, he proposes that the personal income tax should be converted to a consumption-expenditure tax, but one that treats investment abroad as non-deductible (that is, as consumption).

Harberger (1985) then goes on to set out the case for imposing a uniform value-added tax as well as some selective excise taxes on luxury goods in order to achieve the politically (and, he suggests, morally) needed degree of progression at the lowest possible cost in terms of economic efficiency. Finally, he considers in some detail the appropriate role and design of trade taxes, suggesting that although in some instances there may also be a role for limited selective export taxes, on balance for most countries it likely most makes most sense for tariffs to be uniform—though he does note that there is also a good case for a small “tax” to regulate the inflow of foreign debt capital.

One need not agree with all that is said in this short paper to recognize that in less than ten pages, Harberger (1985) manages to sum up in a clear and lucid manner much of the fiscal wisdom of the era—his own classic argument on the incidence of capital taxes in an open economy (Harberger, 1962), as extended by his students and followers; the Carter Commission (1967) view on income tax integration neatly extended to the open economy case; the Meade report (1978) arguments for taxing consumption both through the income and the expenditure paths; Musgrave’s (1969) argument for selective excise taxes in developing countries; the accepted argument—which of course also owe much to his own work—for uniform trade taxes combined with non-conventional views on the rationality of export taxes in some instances and, to finish with, a neat version of the so-called Tobin tax (Haq, Kaul, and Grunberg, 1996).

The definitions and arguments are clear; some important real-world complications ranging from tax treaties to the persistence of unequal evasion opportunities are taken into account, and the argument on the whole is presented in a balanced way. It is hard to find a better concise example of reasoning from “first-best” principles through some of the complexities of the real world to a solid second (or perhaps third) best set of solutions. Not just economic efficiency but many other policy aims of interest in different contexts—taxing foreigners, discouraging evasion, taxing rents, reducing the volatility of capital flows, achieving progressivity—are discussed and factored into the argument. All in all, if the actual tax policy in Latin American countries were as well balanced as the system sketched in Harberger (1985), there would be little need for the present paper.

15 Most of this paper is reprinted in Bird and Oldman (1990), and some of the present text is drawn from the introduction in that volume.
16 Perhaps it should be mentioned that I take a somewhat different view of both the case for corporate income taxes (Bird, 2002) and for integration (Bird, 1987).
Ideas, Interests, and Institutions

Some years ago, Michael Best (1976) analyzed Central American tax policy in essentially a “class” framework, arguing that in principle changes in tax structure, and especially the degree of emphasis on income taxation, reflected largely the changing political balance of power between landlords, capitalists, workers, and peasants. Shortly after his article appeared, the Sandinista government – perhaps the most explicitly leftist regime ever to have power in the region (apart from Cuba)– took over in Nicaragua. What happened to taxes? Two things. First, as Best (1976) would have predicted, the tax ratio rose very quickly, from 18 to 32 percent of GDP within the first five years of the Sandinista regime. Secondly, however, almost all the increased taxes came from regressive indirect taxes, not the progressive income taxes that one might have expected.

As this example suggests, politics matters in taxation, but it does not necessarily dominate. Administrative realities, and ideas, also matter (see Box 2). In the present context, however, I want instead to emphasize the importance of ideas in influencing tax policy. To quote Blyth (2002,p. 274) “…neither material resources nor the self-interest of agents can dictate…ends or tell agents what future to construct. Ideas do this.” Or, in the more colorful words of John Maynard Keynes (1936, pp. 283-84): “practical men, who believe themselves to be quite free from any intellectual influences, are usually the slaves of some defunct economist….soon or late, it is ideas, not vested interests, which are dangerous for good or evil.”

The fiscal reality found in most countries reflects less analysis or empirical realities than a changing mixture of ideas, interests, and institutions. Viewed as a whole, the tax structure that exists seldom seems to have been designed with any particular objective in mind. On the contrary, it often seems, like Topsy, to “have just growed” in ways shaped by both the changing local environment and the changing external context.

Consider, for instance, how the western democracies got into the business of progressive taxation in the first place (see Box 3). In the case of the United States, for example, as Weisman (2002, p. 366) shows, “economic crises and wars helped create a consensus for an income tax that falls most heavily on the wealthiest taxpayers. The consensus [was] forged in the period of 1860 to 1920…..” The lengthy debate about taxes that took place over this period was, he says, not really about taxes at all but rather about “what kind of society Americans wanted.” Since 1970 or so, the ideas about the relevant balance between taxes and society that were similarly forged in most of the western world over the first half of the 20th century have changed.17

17 One might perhaps question the relevance of historical or even comparative experience in analyzing and understanding the problems of Latin American countries today. As a recent book notes, however, “Today’s industrialized countries were yesterday’s developing or transitional economies and for tax policy purposes the demarcation line between them is more likely to be the relative efficiency and integrity of the tax administration, rather than such economic criteria as GDP per capita” (Messere et al., 2003, preface). Of course, as argued in this section, how a tax administration functions is determined largely by more fundamental political factors.
The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design, especially in developing countries, must therefore take the administrative dimension of taxation carefully into account. What can be done may to a considerable extent determine what is done in any country. In some countries, for example, there is a large traditional agricultural sector that is not easily taxed. In others, there is a significant informal (shadow) economy that also is largely outside the formal tax structure. The potentially reachable tax base thus constitutes a smaller portion of total economic activity than in developed countries. The extent of this untaxed economy is, of course, in part a function of tax policy itself. For example, the high payroll tax rates levied in some Latin American countries create an incentive for a large informal economy by discouraging employers from reporting the extent of employment and encouraging the under-reporting of wage levels. The resulting lower tax revenues often lead governments to raise tax rates, further exacerbating incentives to evade taxes. Unfortunately, all too often when a country’s real tax base is small, so, almost by definition, is the administrative capacity to reach it effectively. Improving tax administration is thus central to the choice of tax structures and to improving taxation in developing and transitional countries.

Unfortunately, tax administration is a difficult task even at the best of times and in the best of places, and conditions in few developing countries match these specifications. Moreover, it is inherently country-specific and surprisingly hard to quantify in terms of both outputs and inputs. The "best" tax administration is not simply that which collects the most revenues; facilitating tax compliance is not simply a matter of adequately penalizing noncompliance; tax administration depends as much or more on private as on public actions (and reactions); and there is a complex interaction between various environmental factors, the specifics of substantive and procedural tax law, and the outcome of a given administrative effort. All this makes tax administration a complex matter.

It is thus critical for those concerned with tax policy and its effects on the economy to understand tax administration. In a very real sense, "tax administration is tax policy" (Casanegra de Jantscher, 1990). Maximizing revenue for a given administrative outlay is only one dimension of the task of tax administration. Revenue outcomes may not always be the most appropriate basis for assessing administrative performance. How the revenue is raised - the effect of revenue-generation effort on equity, the political fortunes of the government, and the level of economic welfare - may be equally or more important in some contexts. Similarly, private as well as public costs of tax administration must be taken into account and due attention given to the extent to which revenue is attributable to "enforcement" (the active intervention of the administration) rather than "compliance" (the relatively passive role of the administration as the recipient of revenues generated by other features of the system). Assessing the relation between administrative effort and revenue outcome is thus not a simple task.

Increasing attention has been paid in the last few years to the importance of tax administration and its role in tax reform. Tax administration has a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system. There is a growing conviction among tax policy specialists in developing countries that "policy change without administrative change is nothing" (Bird, 1989) and that it is critical to ensure that "changes in tax policy are compatible with administrative capacity" (World Bank, 1991). For more extensive discussion of what needs to be done to improve that capacity, and how to do it, see Bird and Casanegra (1992) and Bird (2003a).
Alesina and Angeletos (2003) have recently argued that two “models” of redistributive taxation exist in the developed countries. At one position is the United States, with relatively low taxes and low redistribution, while at the other are countries like Sweden, with high taxes and high redistribution. They attribute the difference essentially to self-fulfilling expectations. In the U.S., or so they argue, the general belief is that effort is causally related to income, so that those who make the effort, and consequently receive the income, are entitled to retain a goodly share of the fruits of their efforts. The resulting relatively unequal distribution of income is seen as a fair outcome since it reflects, so it is believed, differential effort to a considerable degree. On the other hand, since taxes are low so are tax distortions (see Section 4 below), with the result that high effort is indeed likely to yield high income, thus fulfilling the initial expectation. In some European countries, on the other hand, Alesina and Angeletos (2003) suggest that the pervasive belief appears to be that high income reflects not so much high effort as good connections or even corruption. Since the high taxes resulting from this belief system so distort effort that the connection between high effort and high income is indeed greatly weakened, this belief too, they suggest, is strongly grounded in the prevalent social reality.

In another recent paper, Peter Lindert (2002) also notes that there are two distinct equilibrium states for modern democratic societies. In some countries (such as the U.S.), the size of government is relatively low; in others (such as Sweden), it is relatively large. Interestingly, however, Lindert notes that the implications of these choices for tax policy are not necessarily what one might expect. As Steinmo (1993) stressed, the U.S. actually has more progressive tax policies in many respects than does Sweden: how can this be explained, given the perceived vast difference in the redistributive characteristics of the two countries? Lindert does so by arguing, in effect, that the larger the government share of economic activity, the more damaging bad tax policy choices can be. Voters, he says, notice and react to such choices, in part by supporting more pro-growth (and less progressive) tax structures, with, for example, lower effective tax rates on capital income, lower property taxes, and relatively higher taxes on labor income, on consumption, and especially on socially damaging activities (smoking, drinking, environmental damage). Low-budget countries, on the other hand, tend to have higher taxes on capital and lower taxes on wages and consumption, thus placing relatively more of the tax burden on more elastic factor supplies, with consequently more damaging effects on resource allocation and growth.

To some, this perspective – though nicely argued in quantitative terms in Lindert (2002) – may seem a bit far-fetched. Actually, however, it is strikingly similar to the conclusions reached in two recent studies of subnational debt policy in the United States (Inman, 2003) and Canada (Bird and Tassonyi, 2003). Like Lindert (2002), these studies suggest strongly that democratic polities do learn from experience, and do, over time, tend to reward more those parties that follow more prudent economic policies. Those who think populists promising immediate delivery of the moon to the voters will invariably win should, it seems, consider more carefully the meaning of Abraham Lincoln’s famous dictum to the effect that one can fool all of the people some of the time and some of the people all of the time, but that one can never fool all of the people all of the time. Economic history appears to tell us that, at least in societies with the “error-correction mechanism” that we call “democracy”, Lincoln was right, at least to some extent. Or, as Blyth (2002, p. 274) puts essentially the same point: “Political economies …are …evolutionary systems populated by agents who learn and apply those lessons in daily practice.”

As Jakee and Turner (2002) note in a somewhat different context, the critical point in such arguments is to ensure that adequate feedback mechanisms are in place to warn when sustainable limits are being breached. Such mechanisms may take the form of the “exit” mechanisms favored by economists (as when over-taxed resources flee a jurisdiction) or the “voice” mechanisms stressed by political scientists (as when governments are changed to carry
out more prudent policies), but they must exist. No government is always competent; none is omniscient; not all are always well-intentioned. Mistakes will be made. The key sustainability problem that all societies face is thus how to minimize the severity of such mistakes. In the story that Lindert (2002) tells, this is done by muting the anti-growth aspects of pro-redistribution spending policy by a more pro-growth tax policy. Redistributional policies that in themselves might have been unsustainable in the long run because they would impose excessive distortionary costs on resource allocation are thus made sustainable in part by direct measures to reform the tax system to reduce such costs.\(^\text{18}\)

All this seems rather neat. Still, there are some obvious problems in reconciling the Alesina-Angeletos and Lindert views. For example, how can the U.S. simultaneously both have low taxes (and hence reward effort) and high tax rates on more elastic factor supplies (thus less pro-growth policy)? Does this mean that the U.S. has, in effect, adopted low taxes to encourage effort (and growth), but it has done so in so inefficient a way that it may have increased effort – and hence supported the self-fulfilling expectation that more effort and more income are positively correlated – while at the same time it has also discouraged growth owing to the exceptionally inefficient form of its tax system. Obviously, much more work is needed to resolve such conundrums – work that, on the whole, seems to require more detailed studies of cross-country comparisons in the Lindert mold, focusing, for example, not on such econometric-friendly but conceptually empty measures as (say) the share of income taxes in total revenues (or in GDP) but rather on more meaningful issues such as the differential marginal tax rates applied to (say) male workers between the ages of 25 and 45, etc. Not only the devil, but a more meaningful approach to the use of comparative international data appears to lie in much more attention to such critical details.

\(^{18}\) In the story told by Bird and Tassonyi (2003), much the same end is achieved by subjecting governments to constant pressures from both exit (market forces) and voice (elections). Macroeconomic policies (subnational borrowing) that in themselves might have led to an unsustainable situation in the long run thus become sustainable over time by an evolution in both institutions (capital markets) and ideas (political rewards for conservative fiscal measures).
In particular, progressive taxation appears to have lost much of its political appeal (Blyth, 2000).\textsuperscript{19} It may have done so because it had done its job, or was thought to have done so. Or it may have done so because it had not done its job, and was increasingly thought to be unable to do so. Or, again, it may have done so because people became increasingly convinced that the economic costs of progressivity were too high to make it worthwhile. In the end, it does not matter much whether any or all of these arguments are right, or to what extent. In politics, perception is reality, and the perception of the appropriate role of the tax system with respect to inequality clearly seems to have changed in most developed countries in recent decades.

As Weisman (2002, p.366) concludes with respect to the United States, “…the search for the right balance is an endless process…. The consensus supporting the legitimacy of the income tax is likely to remain undisturbed. But its progressive nature will always be debated as long as we care about reconciling the competing demands of social equity, economic incentives and the need to pay for an expanding government.” If one thinks in these terms about Latin America, then what seems clear is that no real “consensus” on the “right balance” appears yet to have been achieved. The fact that some developed countries seem to have, as it were, moved on to a new, less progressive consensus does thus not necessarily imply that it is any less important for Latin America to develop its own viable democratic social consensus on the right balance between equity and efficiency in taxation.

As discussed in Box 3, the developed countries have clearly reached different equilibrium positions.\textsuperscript{20} Equally, there is no reason to expect any one “balance” to be right for all countries in Latin America. Although the discussion in the present paper is necessarily in general terms, it must be remembered that, as always with public policy, “no one size fits all.” What is right, or at least feasible, in Chile or Brazil, for example, is likely to continue to differ from what may be sustainable in Colombia or Honduras.

4. Taxation, Growth and Efficiency

Although much has been said and written about the effects of taxation on growth and equity, there is still much that is not well understood about these complex subjects even in developed countries with stable, long-established tax systems and excellent data. Unsurprisingly, matters are even murkier in the changing and sometimes chaotic conditions characteristic of Latin American countries. Consider, for example, the much discussed trade-off between growth and equity. Most societies want to be richer. Most also want the increased wealth to be distributed fairly. Are these objectives compatible? This question is the focus of much theoretical and empirical inquiry and to an even

\textsuperscript{19} Steinmo (2002) suggests that, following the 1986 tax reform in the U.S., the distribution of tax burdens by income quintiles seemed, at least until the most recent (2002) proposals, to be essentially frozen at 1986 levels – not so much because anyone thinks that is the “right” distribution but because no one wants to engage in political fights on the issue.

\textsuperscript{20} As Messere, de Kam, and Heady (2003) show, there has been essentially no “convergence” in either tax levels or structures among OECD countries in recent decades, and they argue there is little reason to expect such convergence in the near future.
greater extent of political and policy controversy. No simple answer applicable to all circumstances exists.

Some argue that, since growth never occurs in all sectors simultaneously, it is inevitably accompanied by increased inequality. Others argue that societies in which resources are distributed more equally will do better in the long term. Still others suggest that, whatever the answer may be, it is often not difficult in particular circumstances to envisage policy measures that are fully compatible with the achievement of both more growth and more equity. While, as always, the best answer for any country depends to a considerable extent upon its specific circumstances, there is certainly some truth in the view that countries may be able, so to speak, to have their fiscal cake (growth) and eat it too (redistribution), at least to some extent.21

The Costs of Taxation

Much of what economists have to say about taxation turns on the deadweight loss associated with taxation. Taxes impose costs in economic terms, and it is obviously in the interests of countries in which, by definition, resources are scarce to use as efficiently as possible the resources that they have, and hence to ensure that the taxes they impose are as efficient as possible. “Efficient resource allocation” may sound like a theoretical abstraction of interest only to economists, but it clearly better than the alternative of, in effect, simply wasting scarce resources and hence making society as a whole worse off.

The confusion apparent in some public discussion of these matters may arise from misunderstanding what is meant by the “costs” of taxation. Most people probably think of such costs in terms of the taxes collected. In economic terms, however, taxes are simply a means of transferring resources from private to public use and are not themselves a cost in economic terms. Economic costs are incurred only when the total volume of resources available for society’s use, whether for public or private purposes, is reduced by taxes. Costs in this sense arise from the process of taxation for several reasons.

First, and most obviously, taxes cost something to collect. On average in developed countries, perhaps 1 percent or so of tax revenues must be devoted to covering the budgetary costs of tax collection. The costs of tax administration may often be relatively higher in developing countries – a recent study in Guatemala, for example, estimated them at 2.5 percent of collections (Mann, 2002) – but they are seldom a significant factor in shaping tax policy

Another real economic cost involved in collecting taxes are the “compliance costs” incurred by taxpayers in meeting their tax obligations, over and above the actual payment of tax. Compliance costs are incurred not only by taxpayers but by all who are involved in the tax process – for example, employers withholding income taxes from employees

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21 For an early application of this thought to Colombia, see Bird (1970). An important policy consideration in all countries is administrative capacity, although, as mentioned earlier, this issue is not developed in detail here (see Box 2)
and banks who collect and remit taxes to government. Costs include the financial and time costs of complying with the tax law, such as acquiring the knowledge and information needed to do so, setting up required accounting systems, obtaining and transmitting the required data, payments to professional advisors and so on.

The measurement of such costs is still in its infancy, but a number of studies of their magnitude and distribution have been carried out in several developed countries (Sandford, 1995). On average, compliance costs in these countries are perhaps four to five times larger than the direct administrative costs incurred by governments. They may be even higher in many developing countries, although data are scarce. Compliance costs are generally quite regressively distributed, and are typically much higher with respect to taxes collected from smaller firms.

Finally, and most importantly, taxes may give rise to what economists call “deadweight” or “distortion” costs. Almost every conceivable tax has the potential to alter decisions made by businesses and individuals as the relative prices they confront are changed. As a rule, the resulting changes in behavior are likely to reduce the efficiency with which resources are used and hence to lower the output and potential well-being of the country as a whole. No matter how well the resources transferred to government through taxation may be used, it is obviously only sensible to limit the negative consequences of such changes in behavior as much as possible.

Decisions to work, for example, are affected by taxes on wages (personal income taxes, wage taxes, social security taxes, and so forth) that reduce the incentive to work. The higher the tax rate on wages in the formal sector, the less attractive it is to work in that sector and the more attractive is untaxed informal sector activity. Consumption taxes too may discourage work, because they raise the amount of time one must work to pay

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22 A recent careful study of compliance costs with respect to the personal income tax in India (Chattopadhyay and Das Gupta, 2002) suggests that such costs were up to ten times higher than in developed countries. This does not of course mean that compliance costs are always so high for personal income tax in developing countries. But they do suggest that a tax like that in India, which is exceptionally complex, shot full of exemptions and concessions, with a highly progressive nominal rate schedule, and administered in an apparently rather arbitrary and capricious fashion, requires substantial reform if it is to be either an efficient or an equitable revenue instrument.

23 There are a few exceptions. Lump-sum taxes, where the tax burden is the same regardless of any behavioral responses by taxpayers, provide one example, much favored by theorists. More importantly in practice, to the extent that taxes fall on economic “rents” — payments to factors above those needed to induce them into the activity concerned — they too may not affect economic activity. Well-designed taxes on natural resources and land, for example, may thus to some extent produce revenue without economic distortion. Finally, in certain instances, taxes — again, if properly designed — may not only not create distortions in economic behavior but may even induce desirable behavior. Certain environmental levies, for example, or even crude proxies such as taxes on fuel, may to some extent have such effects. Such instances of “good” taxes — those with no bad economic effects — should of course be exploited as fully as possible, just as well-designed user charges should, to the extent possible, given public policy objectives, be used to finance certain public sector activities that specifically benefit identifiable individuals or firms. In the end, however, most of the taxes needed to finance government will have to come from other sources and will hence give rise to the efficiency costs discussed in the text.
for goods and services through the market place. Since taxes are not imposed on leisure, it is not surprising that, at the margin, the effect of taxes is likely to discourage (taxed) work.

Of course, taxes not only alter relative prices – in this case, the net (after-tax) wage – but also income. Since people who work will have less net income after a wage tax is imposed, they may choose to work more to offset the income loss. Indeed, in many cases, they may have to work more simply to keep themselves and their families alive. The net effect on work of any tax change reflects both this income effect and the effect of the change in relative prices (the substitution effect). Voluminous studies of the impact of taxes on work exist for many countries, with results varying from country to country depending upon the structure of taxes and the nature of the economy. Income effects may be especially important for low-income people and act as yet another factor fostering the growth of the “informal” or “shadow” economy.

The important point in the present context, however, is that, regardless of the income effect, the substitution effect – the change in relative prices – of taxation in and of itself leads people always and everywhere to alter their work decisions and hence, if those decisions had been economically efficient before the tax, reduces the potential output of the nation. Such substitution effects are the source of efficiency losses from taxation. They may be counterbalanced to greater or lesser degrees by non-fiscal factors, or if the tax revenues are put to good use, but they nonetheless exist. An important concern in designing a good tax system is thus to minimize such effects.

Almost all taxes may affect resource decisions. Consumption taxes, such as the value added tax may discourage the consumption of taxed as opposed to untaxed goods (e.g. housing in some countries). Taxes on gasoline, alcohol, and cigarettes can reduce the consumption of these items. Income taxes, since they tax the return to savings, may alter the amount of savings or the form in which savings are held. For example, failure to tax capital gains until they are realized (taken in cash) encourages the holding of assets that implicitly retain the capital gains without realization in cash.

Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment. Firms may, for example, choose to locate their activities in any of a number of countries for many reasons -- the relative costs of production, access to markets, etc. – but taxes too may affect their choice of location. To the extent taxes lower the after-tax return on investments in a country or a region, the level of investment and hence growth may be lower than it would otherwise

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24 For one such recent study of Colombia, see Alm and López-Castaño (2002). Schneider (2003) estimates that the average size of the “shadow” economy in Latin America is 41% of GDP, ranging from a low of 20% in Chile to a high of 67% in Bolivia. He argues that labor taxes (including social security contributions) are a major factor fostering the growth of this sector.

25 As noted earlier, not all such effects need be bad: for instance, if tobacco consumption falls, people may live longer, healthier and more productive lives. On the other hand, as I note in Section 8 below, the result may still not be considered “fair.”
Corporate income taxes may also affect how corporations structure their finances. For example, retained earnings are encouraged when interest on debt capital is deductible and dividends paid from equity capital are not.

Exactly how important such tax effects are is a matter of considerable debate among analysts even in developed countries, but the consensus is that they are almost certainly much more important than was thought thirty or forty years ago. The efficiency costs of taxation are certainly a considerable multiple of the administrative and compliance costs mentioned above. The lowest estimates for developed countries are perhaps 20-30 percent of revenues collected, and much higher figures are not uncommon (Feldstein, 1997). To the extent such costs are an inevitable consequence of rational policy decisions, (for example, to redistribute income through the fiscal system) they may be considered acceptable by some, as argued in Section 5. Still, it is obviously critical to design taxes to minimize such possible adverse consequences in poor countries.

This point seems obvious to economists, but it seldom seems as clear to others perhaps largely because, although effects such as those mentioned above are real, they are not directly visible. The efficiency cost of taxation arises because something does not happen -- some activity did not occur or occurred in some other form. Output that is not produced, however, is still output – and potential welfare – lost. What you see is not what you could get if the taxes needed to achieve public policy objectives were better designed. Efficiency is no mean virtue anywhere, but it is surely especially important not to waste resources by taxing inefficiently in countries that have few resources to waste..

**Economic Rules for Reform**

Good tax policy thus requires minimizing unnecessary costs of taxation. To do this, experience and analysis suggests that, to the extent possible, three broad rules should be followed:

- First, tax bases should be as broad as possible. A broad-based consumption tax, for example, will still discourage work effort, but choices between taxable and non-taxable goods and services will not be altered if all are taxed. A few items, such as gasoline, tobacco products and alcohol, may be chosen for differentially higher taxation for regulatory reasons or because the demand for these products is relatively unresponsive to taxation so that at any given tax rate efficiency costs

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26 Bird and Chen (1998) estimate the size of tax impact on new investment in five Latin American countries. For discussion of the appropriate methodology for measuring this impact, see Bird and Chen (2002).
27 For a recent survey of the effects of taxes on saving, for example, see Bernheim (2002).
28 In theory, in order to minimize efficiency losses different tax rates should be imposed on each commodity, with higher rates imposed on those goods and services where the changes in behavior are the smallest. To do so, however, requires much more information about how taxes alter behavior than is available in most countries. Moreover, this approach does not take administrative and equity concerns into account. For these reasons, in practice it seems generally advisable to impose a uniform tax rate to the extent possible.
are relatively low and revenues relatively high. Income tax bases too should be as broad as possible, treating all incomes, no matter from what source, as uniformly as possible.

- Second, while of course tax rates must be set at levels needed to finance the appropriate functions of government, they should be as low as possible. Of course, the broader the base, the lower the rate needed to generate a given revenue. In any case, but lower rates are worthwhile in their own right. The reason is simply because, as noted above, the efficiency cost of taxes arises from their effect on relative prices, and the size of this effect is directly related to the tax rate. In fact, the general rule is that the distortionary effect of taxes increases proportionally to the square of the tax rate, so that doubling the rate of a tax implies a fourfold increase in its efficiency costs. From an efficiency perspective, it is thus always better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. In practice, of course, this consideration needs to be balanced against the equity argument for imposing graduated rate schedules (see Section 5).

- Third, from an efficiency perspective, it is particularly important to impose taxes on production with care since such taxes directly affect the location of businesses, alter the ways in which production takes place, change the forms in which business is conducted, and so forth. Taxation at the point of production is nonetheless often essential in developing and transitional countries for a variety of reasons. For instance, it is often simpler in countries with limited administrative capacity to collect excise and even sales taxes at the point of manufacture. In addition, to the extent that taxes are intended to recover the costs of providing public services to businesses they should obviously be imposed directly on producers. Finally, taxes need to be imposed on corporate income both to prevent tax avoidance by retaining earnings within a corporation and to collect taxes from foreign-owned firms (Bird, 2002).

5. Fairness in Taxation

Such at least such are the conventional conclusions that may be distilled from the literature. Quite a different perspective emerges, however, if one takes the view of Wagner (2002, p. 543) that “if governance is mutually beneficial...there is no excess burden for taxation.” His argument is essentially that deadweight losses of taxation should not be taken into account in democratic societies in which budgetary decisions can be assumed, on the whole and over time, to represent the wishes of society in some real sense – indeed, at the very least in a more real sense than any particular normative perspective that may derived from the thinking of one long-dead philosopher or another. In a (Wicksellian) democratic framework in which expenditure and tax decisions are taken conjointly – as set out in detail, for instance, in Breton (1996) – the existing tax

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29 For detailed treatments of user charges and business benefit taxes, see Bird and Tsiopolous (1997) and Bird (2003).
structure, whatever it may be, must be assumed to be imposed in full knowledge of its consequences, reflecting the social judgment that the benefits of the actions financed more than compensate for all costs of taxation. This political economy perspective will be developed further in Section 6 below. First, however, a related distributional comment on the argument in Section 4 above may be helpful.

**Deadweight Loss Revisited**

It has long been clearly understood that since, as a rule, the economic cost of raising public funds is larger than the number of tax dollars raised, the optimal size of the public budget is less than it would be with a more efficient tax system. This message is found in many modern texts in public finance. As Stiglitz (2000, p. 148) says, “since it becomes more costly to obtain public goods when taxation imposes distortions, normally this will imply that the efficient level of public goods is smaller than it would have been with nondistortionary taxation.” “Indeed,” Stiglitz continues, “it appears that much of the debate about the desirable level of public goods provision centers around this issue. Some believe that the distortions associated with the tax system are not very great, while others contend that the cost of attempting to raise additional revenues for public goods is great (pp. 148-149).”

Such arguments, however, unduly neglect not only the political context (Section 6) but also distributional issues. Either they are conducted in single-consumer (or representative consumer) frameworks, where distribution is not an issue, or they assume that all taxpayers are both equal and treated equally. While the need to thus simplify reality is of course analytically understandable, the world does not work this way. The reality of the assumptions used to derive analytical conclusions must always be carefully considered—and, if necessary, the conclusions adjusted—before applying them to real world policy issues.

A quite different approach leading to a quite different conclusion, for example, has been put forth in an important paper by Kaplow (1996), who argues — like Wagner (2002), but for completely different reasons -- that the best general way to treat the so-called “deadweight” economic cost of raising an additional dollar of public revenue is to ignore it. The key to his argument is that he assumes that the distortionary cost of taxes is, for the most part, a reflection of the attempt to redistribute income through the tax system. In this circumstance, as Kaplow (1996, p. 520) puts it: “Knowledge that the aggregate reform—the public good and the tax adjustment, taken together—causes distortion thus provides little guidance, because the existence of distortion is associated with greater redistribution. Whether the net effect is good or bad depends upon the extent of preexisting redistribution and the policymaker’s judgment about the optimal extent of redistribution.” It also, presumably, depends upon whether there is fact any significant redistribution in the first place — somethin which, as we shall see later, is far from clear in the context of Latin America.

Although this argument thus seems overstated especially for developing countries, since many existing distortions arising from taxation cannot plausibly be associated with
any distributive aim, it is, as Ng (2000) demonstrates, not only convincing in principle but fully compatible with even high measures of deadweight costs (as in Feldstein, 1997). Essentially, what Kaplow (1996) assumes is that the source of additional finance is an income tax adjustment that will roughly offset the benefits from the public goods at each income level. When such “benefit taxation” is used, he argues, there is no need for adjusting for distortionary costs because there will, by definition, not be any distortion. It is, he says, wrong to “…focus entirely upon the distortionary costs of the income tax, ignoring that the raison d’être of redistributive taxation is to redistribute income.”30 Just as a feasible lump-sum tax with no distortionary cost such as a poll tax might be considered undesirable on distributional grounds, so an increase in a progressive income tax might be considered worthwhile even though it clearly increases distortion. Of course, this reasoning also suggests that if the source of finance both caused efficiency losses and impacted adversely on the poor, as would many excise taxes,31 it would be doubly undesirable.

It is important to understand exactly what is being argued here. The point is not that there are not often real (and sometimes large) efficiency costs connected with raising public funds. There are such costs, as argued in Section 4. The point is rather that if the finance comes from (good) “benefit” taxes then by definition the shadow and nominal prices are the same, and if it comes from non-benefit taxes it may still be considered worthwhile if the distributive effect of such taxes is considered desirable. Of course, such arguments assume that governments do indeed reflect in some real sense the will of the people. To the extent that Latin American countries are, even in formal terms (Snyder and Samuels, 2001), a long way from being perfect democracies, and indeed in some instances are more likely to be what may perhaps be called “democratically exploitative” states -- that is, states in which those in power use the levers of power in large part for self-aggrandizement or in support of their particular group or interests -- there is certainly still considerable room for worry about the excess burden of taxation.

**Fairness and Inequality**

No matter where one comes out on the deadweight loss issue in principle, concern for fairness or equity always and everywhere remains a central issue in taxation. Indeed, from one perspective, the principal rationale for taxes in the first place may be thought of as an attempt to secure equity. After all, strictly speaking, national governments do not need taxes to secure money because they print the money in the first place. The role of the tax system is instead to take money away from the private sector in as efficient, equitable, and administratively inexpensive way as possible.

Equity, with efficiency and administration, is thus one of the three principal factors shaping any tax system. Of course, exactly what is considered equitable or fair by any particular person may differ from the conceptions held by others. In the end, only

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30 Stiglitz (2000, p. 533) makes a comment in the same spirit: “The use of distortionary taxes is thus an inevitable consequence of our desire to redistribute income, in a world in which the government can observe the characteristics of individuals only imperfectly.”

31 An example, a tax on kerosene, is analyzed in Hughes (1987).
through its political institutions can any country define and implement its view of what is an acceptably fair tax system.

Before discussing further what might be meant by a “fair” tax system, however, it is important to distinguish this possible policy objective clearly from a very different objective sometimes assigned to taxation, namely, altering the inequality of the distribution of income and wealth. Experience everywhere suggests that, for the most part, this latter objective is unattainable. Income distribution, and changes in income distribution, reflect many different forces. It is true that in principle taxes may affect distribution, first by influencing economic decisions (as mentioned in Section 4) and thus the market-generated distributional outcome and, then, secondarily by redistributing those incomes through the fiscal system. The possible extent and limits of what can be done through the tax system to redistribute income are discussed further in Section 7 below, but the point to be noted here is that, no matter how extreme such redistribution might be, it is unlikely to have much effect on the overall distribution of income.32

Tax systems can and should be concerned both with relieving poverty by untaxing the poor (Section 8) and with assuring that the rich pay their fair share of the cost of government (Section 9). But taxation cannot effectively redistribute income to any significant extent in Latin America, and saddling tax designers with this hopeless task is likely to make them ineffective in doing what they should do – designing better and more effective tax systems that will provide sufficient revenues to carry out sensibly growth-oriented spending policies. As IDB (1998, p.187) noted, “the redistributive potential of a tax and expenditure system tends to be greater when tax distortions are minimized and spending efficiency is maximized. Instead of a conflict between redistribution and efficiency, there is complementarity.” Or, more correctly, there may be such complementarity, provided the funds raised by a good tax system are spent well – a subject that cannot be further discussed here.

The issue of fairness in taxation may be approached in various ways. For example, one may focus on the specific tax burdens imposed on taxpayers who are considered to be in the same (or different) economic circumstances. Alternatively, one may instead focus on the overall effects of taxation on income and level of well-being. The policy implications of these two approaches may be quite different. The first approach emphasizes the distributional implications of a given tax burden arising from the interaction of the details of particular taxes. Unfortunately, although proposals to reform taxes based on such analysis may indeed improve particular measures of horizontal and vertical equity within the limited group who are actually subject to the full legal burden of the taxes in question, they may also have implications for others that may in some instance make the system as a whole less fair. From the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income. Both expenditures and taxes should therefore be taken into account in considering how government policy affects the distribution of income, as well as the overall equity implications of any tax change.

32 This point is stressed in Harberger (2003) and demonstrated empirically for Chile by Engel, Galevotic, and Raddatz (1999).
Consider, for example, the case of a country like Colombia in which the big untaxed sector is not traditional agriculture (as in many low-income countries) but rather the relatively large shadow economy. The existence of such a sector may have important implications for the effects of particular tax policy.\(^{33}\) For example, to the extent a VAT functions properly, it will to some extent serve essentially the same function as a presumptive tax on the informal sector (since credits are only available for firms that are registered as taxpayers and those earning income in the shadow sector are taxed when they purchase commodities through the formal sector).

On the other hand, if many high-income recipients operate through the shadow economy, the effects on equity of increasing the progressivity of the personal income tax are not always obvious. Government employees and employees of large, formal market firms may be the primary personal income taxpayers and hence bear the brunt of such changes. In such circumstances, it is not inconceivable that indirect taxes such as a VAT and especially certain excises in “higher-income” consumption goods such as motor vehicles, may be more progressive than a personal income tax that in reality falls largely on a limited group of wage earners.\(^{34}\)

The point is that it is important in thinking about taxation and equity to focus not on preconceived notions about labels -- for example, that anything called a personal income tax is, by definition, progressive, while anything called a VAT is, by definition, regressive – but rather on the reality of how taxes work in practice. All taxes, whether on income or consumption, may affect equity in many and complex ways. For example, they may treat people who are in essentially the same economic position differently (horizontal equity). For example, taxes may fall more heavily on those who consume alcohol than on those who consume housing, or on those who get their income in the form of wages rather than from farms or dividends.

Taxes may also differ in their effects on income distribution (vertical equity). They may tax the rich relatively more (progressivity) or less ( regressivity) than the poor. Some countries may wish to favor cities, other rural areas. Some may choose to favor rich savers in the name of growth; others the poor, in the name of redistribution. Like most policy instruments, tax policy can play many tunes. What is critical from an equity perspective is, first, to be aware of the equity implications of tax reforms for different groups, and, second, to ensure that the actual outcome of such reforms is consistent with the intended outcome.

\(^{33}\) For some discussion of the way in which tax incidence varies in the presence of an untaxed sector, see Alm and Martinez-Vazquez (2003).

\(^{34}\) A tax is considered progressive when the tax burden as a percent of income is greater for higher income households than for lower income households, proportional if the percentage of income paid in taxes stays constant as income rises, and regressive if the percentage paid in taxes falls as income rises. A higher income taxpayer will normally bear a larger absolute tax liability than a lower income taxpayer, regardless of whether the tax is progressive, proportional or regressive, so the difference between the three concepts is how rapidly taxes rise with income, not whether taxes rise with income.
A recent study, for example, used the share of total taxes collected by "direct" (income) taxes as a rough indicator of the equity of the tax system (Das Gupta, 2002). As noted earlier, however, this measure does not seem meaningful in countries in which most direct taxes are generally collected from enterprises, as is true everywhere in Latin America. The traditional view has been that as countries developed, this ratio would rise, that is, that direct taxes would become relatively more important. As seen in Section 2, this has not been happening in Latin America, but it does not follow that tax systems have been becoming less fair as a result.

**What is Fair?**

Of course, it is in any case not always clear what “fairness” means. Equality of outcome and equality of opportunity, for example, are not only very different concepts but in many ways in opposition. Equality is a relative, not an absolute concept, and it is a value-laden one. To some, there can never be enough equality; to others, a certain degree of inequality is acceptable if it rewards differential effort; to still others, excessive inequality may simply be “unlovely” (Simons, 1938). In most societies, some level of inequality seems acceptable to most, although just how much inequality may be a matter of considerable dispute. As mentioned earlier, the only way we have to solve such problems is through our political institutions, imperfect as they are.

Even if one can agree on what equality means, and how much of it one wants, it is hard to know how much one has, or how to measure it. It may be measured in terms of income, consumption, access to services, or perhaps in more political terms, access to power. As Sharpe (2003) notes in a recent review of the evidence in developed countries, not only is there little evidence either way of the connections between equality and growth but it is also surprisingly hard to pin down just what has been happening with respect to inequality, since different measures behave differently at different times in different countries.

What is considered equitable or fair by one person may differ from the conceptions held by others. Traditionally, tax scholars have defined fairness in terms of horizontal and vertical equity. Horizontal equity requires those in similar circumstances to pay the same amount of taxes. For apportioning tax liability, horizontal equity often embraces some notion of ability or capacity to pay. Vertical equity requires “appropriate” differences among taxpayers in different economic circumstances.

Both concepts have great intuitive appeal. Those who have the same ability to pay should bear the same tax liability. Similarly, it sounds like good sense for there to be appropriate differences for taxpayers in different situations. Unfortunately, both concepts may have limited usefulness in tax policy debates.

For instance, the concept of horizontal equity has been challenged as being incomplete, not helpful, and derivative. As an example, an income tax can completely satisfy horizontal equity requirements only if we assume individuals have identical tastes.

35 Chu, Davoodi, and Gupta (2000) take a similar position, as noted in Section 7 below.
and a single type of ability or income. Once we allow preferences to vary and provide for differences in ability or income, then only a tax based on an individual’s ability to earn income, rather than a tax on actual earnings, can effectively provide for equal taxation for those in equal positions. In addition, the concept of horizontal equity may be incomplete to the extent it focuses only on a short time period, such as one year, or fails to consider the impact of all taxes, or ignores the provision of government services or other benefits. The concept of horizontal equity is thus not very useful unless we can determine precisely which differences are important and also just why these differences justify different tax treatment.

Similarly, much disagreement exists about the usefulness of the concept of vertical equity and what constitutes appropriate differences in treatment. Consider several possible conceptions of fairness. To some, fairness could require that all individuals pay the same amount of tax. Thus, one could design a tax system that imposes a head tax on each individual over the age of 18 years. Fairness could also require all taxpayers to pay the same rate of tax on their income. In some countries, “flat tax” or “single rate tax” rhetoric enjoys great popularity. While most flat rate proposals provide for a high threshold (zero rate bracket) before the imposition of the flat rate, the notion of one tax rate for all strikes some as an equitable manner of determining tax liability. To others, however, fairness requires taxpayers with higher income to pay a higher percentage of their income in tax. Many find it attractive to assess tax on the basis of “ability to pay,” in the sense that the rich contribute relatively more to financing government operations.

Some of these points may be illustrated by considering the relative fairness of consumption taxes versus income taxes. Some consumption tax proponents question whether any income tax system can be fair. There are several, somewhat related, strands to this position. One approach takes a societal view. Income is what individuals contribute to society; consumption is what they take away from the pot. Therefore, if we want a society that will continue to grow and prosper, we are better off taxing consumption rather than income. A second approach considers consumption as a better measure of a household’s ability to pay. Because of the greater variations in income over a persons’ or households’ lifetime, it may be better to use consumption as the base for taxation rather than income. Finally, income taxes impose higher taxes on households with higher savings. As such, the income tax system penalizes savers over those who consume currently.

On the other hand, proponents of income tax claim that a person’s net increase in economic wealth is a better measurement of ability to pay than the use of their income. That is, an income tax proponent would say the person who earns $1 million and spend $10 has a greater ability to pay than the person who earns $10 and spends $10. Under a consumption tax, both would bear the same tax burden while under an income tax, the first person would generally bear a much greater tax burden.

Such discussions of fairness can and have been carried on for decades or even centuries without reaching consensus. Although one may personally find one or another approach satisfying, such satisfaction, is only of limited policy relevance. Simply saying
that we should accord equal treatment to equals, for example, adds little to tax policy discussions. We need to choose an ethical framework before making any comparisons—whether comparing equals, or making “appropriate” comparisons among unequals. Without such a fundamental framework one cannot evaluate the relative fairness of different proposals or different tax regimes. Perhaps the best economists can do is to determine the distributive consequences of a proposal or regime, and then let the country decide. In the end, to repeat, we must always remember that only a country’s political institutions can define and implement what can be agreed to be an acceptably fair tax system.

6. The Political Economy of Taxation

The central problem of public economics is: What should governments do? Determining what governments should do is inseparably entangled with the question of how whatever they do is to be financed. As noted in Section 5, the proper treatment of efficiency costs is inextricably related to distributional concerns. It is thus critical in determining what governments should do to ensure that the linkage between expenditure and revenue decisions is as clearly established as possible in the budgetary and political process.36 The relevance of some of the arguments in Section 5 to the far from perfect democracies and the highly distorted tax systems prevalent in many countries of Latin America may be questioned.

Nonetheless, viewed in historical perspective, as Wicksell (1896/1958) argued over a century ago, allocative decisions in the public sector will be made efficiently only if they are financed efficiently – that is, by benefit taxes, which may perhaps be broadly understood in this context as taxes deliberately chosen to finance specific expenditures in the full knowledge of the allocative consequences of both expenditures and taxes. Wicksell further argued that even such “good” taxes would really only be normatively and politically acceptable if society had already adjusted the distribution of income and wealth to accord with the politically-acceptable “just” distribution of income. Alternatively, however, as discussed in Section 5, one might view any “accepted” distortion to achieve distributional goals as part of the “wicksellian” bargain.

In many ways, then, the central question of tax policy – though it is seldom discussed in these terms – concerns how to make the “wicksellian connection” (Breton, 1996) operational so that good decisions—that is, decisions that, as closely as practically feasible, reflect people’s real preferences—are made on both sides of the budget. For example, much of the rationale for “good” decentralization—that is, decentralization that increases accountability along the lines sketched, for example, in Bird (2001)—lies precisely in such arguments. The same is true of such other possible ways of linking more closely financing and expenditure decisions as user charge financing or capital budgeting. Such practices may in some instances yield results worse from some

36 The discussion here focuses on (non-benefit) taxation. To the extent public expenditures are financed from charges, non-tax revenues, and borrowing, other considerations may come into play but these issues cannot be discussed adequately here.
perspectives than those that might have emerged with a soundly conceived and executed comprehensive budgetary system and a uniformly applied expenditure evaluation system along conventionally recommended lines. Nonetheless, the fact that they can be done wrongly does not detract from the basic argument that, if done rightly, they will produce outcomes more in accordance with society’s wishes and resources.

The key to “good” fiscal outcomes lies not in any particular budgetary or financing procedure but rather in implementing a public finance system that, to the extent possible, links specific expenditure and revenue decisions as transparently as possible. Unless one is prepared to adopt the untenable role of the Samuelsonian “ethical observer,” surely the ultimate deciders of what should be done should be those who are most directly affected. The best that can be done to help the relevant decision-makers make the “right” decision is thus to ensure that they and all those affected are made as aware as possible of all the relevant consequences. In the end, then, for a country to implement a better tax system – better in the sense of giving the people what they want – it must have a better political system that transmutes citizen preferences into policy decisions as efficiently as possible. “Democracy,” as Churchill reportedly once said, “is the worst of all political systems -- except for all the others that have ever been tried.”

Of course, taxation is always and everywhere what has been called a “contested concept” (Sabates and Schneider, 2003). Some pay; some don’t pay. Some pay more than others. Some receive compensating services; some do not. Such matters are, in democratic states, resolved through political channels. Indeed, history suggests that the need to secure an adequate degree of consensus from the taxed is one of the principal ways in which, over the centuries, democratic institutions have spread. No non-dictatorial government in this age of information and mobility can long stay in power without securing a certain degree of consent from the populace, not least in the area of taxation. State legitimacy thus rests to a considerable extent on citizens’ “quasi-voluntary compliance” (Levi, 1988) with respect to taxation. To secure such compliance, tax systems must, over time, in some sense represent the basic values of at least a minimum supporting coalition of the population.

No matter how good its political institutions, however, any country will always encounter difficulties in dealing with distributive issues. How one thinks about taxes and inequality largely reflects one’s ideas of fairness or social justice, and, as stressed in Section 5, different people invariably have different beliefs about what is fair – beliefs which may, or may not, have some objective basis. People may have different beliefs for many reasons: because they do not know the truth, because no one knows the truth, because they have been misled about the truth (for example, by the rich who are against redistribution), or just because they see things differently. Successful politicians are those who can manage such conflicts, and one way to do so, as discussed earlier, is by making the wicksellian connection as plausible as possible to most people.37 Unless this

37 As noted in Box 3, different countries may of course do this in different ways. There are, of course, many possible alternative approaches to the politics of taxation: for a useful survey, see Lledo, Schneider, and Moore (2003). For an extended formal analysis, see Hettich and Winer (1999).
is done satisfactorily, the long-term political sustainability of any tax system remains questionable.

7. Who Pays the Taxes?

Who pays the taxes? A recent thorough review of quantitative studies of tax incidence in developing countries (Chu, Davoodi, and Gupta, 2000) finds that on the whole taxes have little redistributive effect, largely because of the heavy dependence on indirect taxes in most countries.\(^{38}\) They find that tax structure is the most important factor in determining this outcome, since income taxes are, they say, basically progressive and consumption taxes are not. With respect to Latin America, while taxes have increased in most countries, income taxes have not, while inequality has also increased, so that there is little evidence of fiscal redistribution.

Shome (1999) reviewed Latin American tax trends in more detail than in Section 2 for the period from the mid-1980s to the late 1990s. With respect to the personal income tax, in addition to the general fall in the top marginal rate already mentioned in Section 2, he noted its application to a lower level of income, the rise in the lowest rate and the corresponding rise in the threshold to which that rate is applied. In his view, the net result in many countries was a decrease in the income-taxpaying population and hence a continuation of the continent’s long tradition of low reliance on the personal income tax, especially when coupled with such other long-standing problems as excessive erosion of the base.

Similarly, corporate income tax rates also fell and other taxes on capital (e.g. capital gains and withholding taxes) also declined. As for consumption taxes, VATs are now almost universal and in most countries rates have gone up over time as VAT has continued to be the main source of government revenues. While tax/GDP ratios increased over the 1980s, only in a few low-tax countries did they increase further in the 1990s, and, as already noted in Section 2, the tax mix in most countries did not alter much.

Given the low importance of personal income taxes, the direct redistributive leverage of the tax system in most countries is, on its face, very small. It is thus not surprising that Chu, Davoodi, and Gupta (2000), like Bird and De Wulf (1973) three decades earlier, found little evidence of much fiscal redistribution in Latin America, despite the sometimes wrenching tax changes undergone by many countries during this period. The evidence thus seems to show that as yet no country seems to have managed to achieve the combination of the desire to redistribute, good leadership, a relatively effective state, and good luck that seems needed to do much in the way of direct fiscal redistribution. Indeed, the most recent evidence is that not much can be done in any case.

\(^{38}\) For other recent reviews, see Martinez-Vazquez (2001) and Gemmell and Morrissey (2002).
As Engel, Galetovic and Raddatz (1999) show in detail for Chile -- which has by far the most effective tax system in Latin America\(^39\) -- the present system is actually slightly regressive (Gini coefficient pretax is 0.4883 but rises to 0.4961 after taxes). Even if the income tax were made much more progressive by eliminating not only all tax allowances but also all (estimated) underreporting of income, the Gini would fall to only 0.4837, and the income of the top decile would fall from the pretax 13.41 times the income of the bottom decile to only 13.37. The average income taxes paid by the top decile after such a drastic (and probably unattainable) reform would still be less than the amount they pay in VAT.

More generally, Engel, Galetovic and Raddatz (1999) argue that the more unequal the pretax distribution, the greater the distortion costs and the less the redistributive effect of progressive taxation. Their conclusion is that the most important factor affecting the distributional impact of the tax system is how much revenue it generates for the public sector, thus potentially financing expenditures such as on education that do impact significantly on income distribution.\(^40\) For this reason, they suggest that a broad-based consumption tax like the VAT is the best foundation for a redistributive fiscal system.

**Do the Numbers Mean Much?**

It is not clear that the “evidence” provided even by such careful incidence studies as that by Engel et al. (1999) is worth much. Few seem to realize how meaningless statements such as “most of the burden of the tax system falls on the bottom two income quintiles” are. Such statements are based on a series of assumptions about the incidence of different taxes that are invariably subject to considerable dispute (Whalley, 1984)\(^41\) and that in practice – though not in most analyses – depend upon many factors specific to a particular country at a particular time (Shah and Whalley, 1990) -- for instance, with respect to market structures and macroeconomic conditions.\(^42\)

The economic incidence of a tax (at least in the long run) is determined by market conditions, and not by whether the tax is legally imposed on the buyer or the seller. It is often difficult to figure out just who does pay certain taxes in the economically relevant sense of having lower real incomes as the result of the imposition of the tax. Businesses attempt pass on (shift) taxes whenever they can to someone else -- to consumers through higher product prices, to workers through lower wages, to owners of land through lower land prices. The incidence of a business or corporate income tax thus depends on such

\(^39\) As one small illustration, note that VAT evasion in Chile is estimated to be about 20%, compared to the range from 30% (Uruguay) to 68% (Peru) estimated for other large Latin American countries (Sour, 2003). Similarly, Schneider (2003) notes that the shadow economy in Chile is 20% compared to the Latin average of 41%.

\(^40\) IDB (1998) says essentially the same thing.

\(^41\) To illustrate, Harberger (2003) suggests that Engel, Galetovic and Raddatz (1999) underestimate the regressivity of the Chilean system because they overestimate the progressivity of the corporation income tax in an open economy.

\(^42\) Engel, Galetovic and Raddatz (1999) recognize this argument, but suggest it is not relevant for Chile which is essentially, they say, more like a European (developed) than a Latin American country (an argument supported by the figures in note 39 above).
factors as the openness of the overall economy in terms of the inflows and outflows of
capital investment, as well as on the extent to which capital moves between the corporate
and unincorporated sectors, the relative capital-intensity of corporations, and the
elasticity of demand for goods produced by corporations and other businesses. None of
these factors is easy to measure, and neither is the incidence of taxes on business.
Further, since differing economic conditions in different countries mean that taxes that
have the same legal incidence may have a quite different economic incidence (Shah and
Whalley, 1990), the specific characteristics of each country need to be taken into account
when evaluating the economic incidence of each tax.

Moreover, when one attempts to compute the total fiscal burden there is an
important “addition” problem, namely that the whole – the reported incidence – is not
simply the sum of the separate parts of the analysis, which are themselves often suspect.
This is so for several compelling reasons.

- First, suppose that it is assumed, as is commonly done in incidence
  analysis, that personal income taxes are borne entirely by the persons who
  pay them and also that sales taxes are borne entirely by those who buy the
  taxed goods. Think of the underlying assumptions about market
  conditions. If factor taxes are borne entirely by factors, then presumably
  either factor supply is completely inelastic or factor demand is completely
  elastic. But if product taxes are borne entirely by consumers, then
  presumably either product demand is completely inelastic or product
  supply is completely elastic. One cannot have it both ways (Prest, 1955):
  either supply (like demand) is elastic or inelastic – it cannot be both at
  once. But conventional incidence analysis in effect assumes that it is.

- Second, to say that the “burden” of taxes is, e.g., X percent of GDP and is
distributed in such and such away among various economic agents
(broadly related to their contribution to, and use of, national income) is to
assume that both the level and the sources and uses of GDP are invariant
to the level and structure of the tax system. Essentially, what the usual
incidence analysis does is to quantify a so-called “differential” incidence
analysis, that is, an analysis that assumes that everything else remains the
same because exactly the same amount of resources are taken from the
same agents by (usually) a proportional income tax. But would production
structures remain the same with such a tax, would the distribution of pre-
tax income remain the same, would the level of output remain the same,
would, for that matter, the pace and nature of technological change remain
the same? On the contrary, relative prices, output composition and level,
and technological change would all be expected to alter with a different
tax system, so the conceptual exercise of comparing the incidence of a
real tax structure with an imaginary counterfactual is fundamentally
flawed since it holds constant what simply cannot be held constant
(Meerman, 1978).
Such considerations suggest that such common questions as “How much do the poor pay in taxes?” are conceptually, and hence empirically, simply not answerable in any definitive way. This is not a question of method: such techniques as computable general equilibrium analysis, generational accounting, and so on are useful for many purposes, but they, like the simple exercise of putting numerical flesh on theoretical assumptions about the incidence of particular taxes, cannot answer such questions. Nonetheless, as the surveys cited earlier show, many analysts attempt to do just this, perhaps on the grounds that if trained economists do not try to do so sensibly someone else will do so less sensibly, and often for narrow political reasons.

Some analytical and empirical advances in incidence analysis have of course been made over the years, but on the whole it is not terribly unfair to say that we know little more about tax incidence now than we did 30 years ago. To illustrate, Gemmell and Morrissey (2002) in their useful recent review of the distributional effects of taxation conclude that, with respect to indirect taxes, modern tax analysis suggests the following conclusions on distributional grounds:

1. There should be more taxation of private transport (which would of course also be sensible on efficiency grounds);
2. VAT is better than excises or import taxes;
3. Export taxes are not a good idea;
4. Taxes on kerosene are often strongly regressive
5. And the incidence of taxes on alcohol and tobacco is very variable.

There is nothing wrong with any of these conclusions. But there is also nothing new about any of them. Gemmell and Morrissey (2002) rest their arguments for such means largely on the fairly recent “welfare-dominance” approach (Yitzhaki and Slemrod, 1991). They could equally have based them on the “optimal tax reform” approach of Ahmad and Stern (1991) or for that matter on any of dozens of country studies over the last fifty years. Indeed, perhaps the most interesting question arising from their review is why so little has been done anywhere in response to such repeated recommendations for a more rational indirect tax system – with the notable, and very important, exceptions of raising the VAT and lowering export duties (both of which of course have for decades been strongly supported by the IMF).

**Does It Matter?**

The preceding argument on the futility of studies of overall tax incidence may seem unduly nihilistic. The real policy questions in taxation, however, are almost never...
related to the “who pays how much” that incidence studies such as those reviewed above attempt to calculate. Rather, the relevant question is almost always “who will pay more (or less) if this or that particular change is made.” If the change is small enough, we may be able to assume that relative prices will not change and carry out a simple partial-equilibrium analysis. Usually, however, some form of general-equilibrium analysis, with all the attendant sensitivity to parameter choices, clearing mechanisms, and the like will be necessary.\footnote{For an excellent recent example, see the study of Colombia by Rutherford, Light, and Barrera (2002).} Whichever method may be used, the key point is always and everywhere both more meaningful and more policy-relevant to analyze the incidence of taxation at the margin, as it were, rather than “on the average.”\footnote{This is essentially the same point as made by e.g. Ahmad and Stern (1991) with respect to the greater ease and meaningfulness of analyzing “optimal tax reform” rather than “optimal tax policy” per se.} The assumptions needed to do so are less heroic, more testable, and more believable than those needed to study the incidence of the tax system as a whole, and the results may help answer the critical policy question of the distributional impact of proposed policy reforms.\footnote{This is, for example, the context of the analysis in Bird and Miller (1989). Of course, the probative value attached to a particular estimated incidence outcome may differ if, for example, the existing tax system is considered to be highly regressive or highly progressive, and total incidence studies may be useful in forming such perceptions, but, to repeat, such studies are neither necessary nor helpful in analyzing particular reform packages.}

Of course, as in much so-called empirical marginal analysis, even the results of “policy reform” studies are themselves really, as it were, “on the average” in the sense that the particular incidence of, say, a given increase in personal income tax rates may vary considerably from person to person at a given income level depending on his or her specific market conditions. To illustrate, one study in Canada suggested that self-employed dentists were able to shift forward (through higher prices) all the burden of such an increase (Schaafsma, 1990). On the other hand, to the extent that high-income recipients in many Latin American countries are essentially collecting “rents” – exploiting political connections and the like – taxes on such rents would presumably not be shifted (and hence would also be economically costless).

Despite all the problems of incidence analysis, it remains important to do the best we can – though it is equally important not to overstate what we can do. Some have argued that economists should stick to their professional last and concentrate only on efficiency, leaving equity for those better equipped to deal with it. As discussed in Section 3 above, however, unless economists explicitly take distributional aspects into account and indeed put them at the forefront of analysis, economic analysis will continue to run the risk of serious misuse by those with distributional (or anti-distributional) axes to grind. Those concerned with the real “sustainability” of policy (in political economy terms) thus need to pay more, not less, attention to distributional issues. Distributional issues matter in tax policy. In fact, often such issues dominate in the minds of those who shape that policy. From this perspective, the general failure of policy economists to say anything very useful about distributional issues has (as noted in Section 3) all too often relegated them, and their evidence, to the sidelines in policy discussion.
8. Untaxing the Poor

I noted earlier that taxation cannot really alter income distribution much. It can also not make the poor richer, but it can certainly make them poorer. Some developed countries, such as Canada and the United States, use their tax systems to provide income support to certain low-income people. Such systems, however, require both that the tax administration is efficient and that most people file tax returns. Neither condition is satisfied in most Latin American countries. Any serious fiscal attempts at poverty alleviation must therefore be undertaken primarily on the expenditure side of the budget. Nonetheless, it is important not to make the poor even poorer through taxes.

In this connection, as Gemmell and Morrissey (2002) correctly emphasized (see Section 7), one needs to pay special attention to the details of indirect taxation. To illustrate, as Bird and Miller (1989) showed for Jamaica, exempting only five specific items from VAT reduced the burden imposed on the poorest 40% of the population by half. It is true, of course, that much of the benefit of such exemptions would flow to higher-income groups, but – absent an efficient offsetting transfer system – there was no more effective way to offset this regressivity. Similarly, reducing or removing obviously regressive excises (and import duties) – for example, on food items or (in many countries) kerosene – is another obvious measure.

Of course, “good“ taxes need not be progressive taxes. To illustrate, an important recent study (Jha and Chaloupka, 2000) advocated that all countries should consider imposing much higher tobacco taxes both because of the externalities associated with smoking and because there is significant empirical evidence that those most deterred by higher prices are younger smokers. Governments around the world, many of which already tax tobacco fairly heavily -- essentially because they can collect a lot of money from some trapped (addicted) consumers -- may seize on such arguments to justify levying still higher taxes on those who smoke.

Unfortunately, there are three offsetting arguments to what may seem to be an overwhelmingly attractive case, on both health and revenue grounds, for taxing tobacco more heavily.

- First, tobacco taxes are perhaps the most consistently regressive of all taxes. Lower income smokers are those who are most heavily burdened by such taxes. There is no way most developing countries can overcome this regressivity by offsetting transfer policies.
- Second, smuggling creates a severe constraint on the tolerable height of tobacco taxes. Again, this problem is especially serious in countries in which the underground economy is already relatively large and enforcement is weak.

49 See also Rutherford, Light, and Barrera (2002) on the importance of exemptions in reducing the regressivity of Colombia’s VAT. Nonetheless, as they recognize, the reduction in tax effectiveness – and hence tax yield – resulting from these exemptions may outweigh any direct redistributive benefits by reducing the capacity of the public sector to finance more effectively redistributive (and often growth-producing) expenditures.
• Finally, the externality arguments used to justify high tobacco taxation do not, in some cases, support taxes as high as those that are already imposed and are especially unlikely to do in countries that do not have large publicly-funded health care services.

Striking the right balance between these various considerations is not easy in any country, but it seems fair to say that there is unlikely to be an unexploited, distributionally costless revenue bonanza for any Latin American country in increased tobacco taxation.

Finally, in many instances, as Gemmell and Morissey (2002) also note, the most important “taxes” affecting the poor are not formal taxes levied in the government budget but rather “implicit” taxes. Two examples may be cited. First, in some less developed countries in which formal government structures do not function very efficiently at all, there may be many forms of “informal” taxation, perhaps particularly at the local level, to which poorer people are subject, such as bribes and exactions of various kinds. While not unknown in Latin America, this seems unlikely to be a big problem in most countries of the region.

More generally, as explored at length in Bird (1991) there are many more general forms of “implicit taxation” to be found in many Latin American countries. Examples include the well-known “inflation tax” as well as many instances of “regulation as taxation” such as “quasi-taxes” imposed as a result of trade controls, price controls, credit controls, foreign exchange controls, capital market controls and so on. There is no budgetary evidence of such transactions. No legislature passes a tax act. No tax collector calls at your house. No taxpayer has any occasion to complain – indeed, most do not even know they are taxpayers. Still, the deed is done. You are poorer (and someone else is often richer) as a result of government action. Even if something does not look like a tax, if it acts like a tax and has effects like a tax, it seems sensible to think of it as a tax for many purposes.

Despite a few pioneering efforts it remains difficult to estimate the quantitative importance of such implicit taxes in any country, and it is impossible to say anything definitive about their importance in comparative international terms. But what does seem clear is that many aspects of government policy have “tax-like” effects on economic decisions, that such implicit taxes are almost certainly more important in less developed countries, and that – although one appears to have systematically studied this matter – on balance the burden of such taxes likely falls disproportionately on the poor, the weak, and the unrepresented.

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50 As Prest (1985) defined it: “By analogy with an explicit tax, an implicit tax must have the general economic characteristics of compulsory deprivation [of private sector purchasing power]; but without there being any flow of funds…from the private to the public coffers. … With an implicit tax, Group A may find its purchasing power reduced whilst Group B’s increases; but such a transfer takes place by means other than through the government’s formal tax-collection and expenditure-disbursement machinery [though due in some fairly direct way to government action].”

51 In addition to Prest (1985) and Bird (1991), see Rabuska and Bartlett (1985).
9. Taxing the Rich

At the other end of the income scale, taxation is one of the few ways in which the wealthy may be made less wealthy, short of outright confiscation.\(^{52}\) Although past attempts to redistribute income through taxation have not been very effective in most developing countries, it may nonetheless be important in political terms to impose highly visible taxes on those who gain the most from economic development – bearing in mind, of course, the need at the same time to minimize the efficiency costs of unduly high tax rates. Sustainable tax policy needs to be accepted as fair by those affected. Even in the poorest countries, for example, automobiles and other luxury products are more visible than income, so that it should be feasible to collect progressive taxes on these items, and most people would consider it fair to do so.\(^{53}\) Striking the right balance in such matters is what good tax policy is all about.

Two interesting features of inequality in Latin America from a fiscal perspective are (1) the extent to which it arises from a very high degree of concentration at the very top of the income distribution and (2) its relation to the extremely unequal distribution of land. The second of these points has of course long been recognized, as shown by the long, and not too successful, history of attempts at direct land reform in the region (Dorner, 1992). The fiscal path to inducing land reform has had no more success, as discussed at length in Bird (1974). Still, more could and should be done with property taxes, which at present account for only about 0.3% of GDP for the region as a whole (Stotsky and WoldeMariam, 2002).

Property tax revenues are low in most Latin American countries. The coverage of the tax is not comprehensive, assessments are low, and collection rates are also often low. Although nominal rates are also low, governments usually find rate increases in this very visible tax difficult to sell politically. Simply raising the legal tax rate would in any case usually burden only the few from whom taxes are actually collected. Increased nominal rates are likely to be acceptable only along with improvements in tax administration such as more comprehensive coverage, better assessments, more frequent assessment re-valuations, and enforced penalties for late payment.\(^{54}\)

Nonetheless, the property tax remains the predominant option for raising revenues at the local government level. The potential yield of land and property taxes is unlikely to be huge, revenues from this source will not be very elastic, and administrative costs are substantial. But an expanded property tax remains both a logical and a desirable objective for many countries, particularly those, like many in Latin America, in which local governments are expected to play an increasing role in allocating public sector resources. Engerman and Sokoloff (2001) argue that one reason for the relatively

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\(^{52}\) Another issue, not discussed in this paper, is the importance of charging properly for services provided by the public sector. There are few more egregious “reverse transfers” than those bestowed on the well-off in many Latin American countries by free (or heavily subsidized) higher education, for example.

\(^{53}\) As Hughes (1987) notes, taxing fuel correctly can be especially difficult in countries like Indonesia in which petroleum products (in this case, kerosene) are an essential consumption item for the poorest people.

\(^{54}\) For a recent discussion of land and property tax policy, see Bird and Slack (2003).
persistent inequality in Latin America compared to North America is the much weaker role of local government in the former which in turn reflects the underlying political capture of the central government by the dominant elites.

An important aspect of fiscal decentralization, if done well, is precisely that it strengthens the “wicksellian connection” between taxing and expenditure decisions stressed in Section 6. Decentralization may, for instance, be conducive to including the poor more fully in decisions, as Faguet (1998) demonstrates has happened to at least some extent in Bolivia. A tax that is both almost certainly progressive in its incidence in Latin American conditions as well as (if properly designed and implemented) potentially relatively allocatively efficient, and in addition may be thought of as (so to speak) “democracy-facilitating” is not to be sneered at. Land and property tax reform should thus be high on the “to do” list of any progressive tax reformer.

The first point mentioned in the introductory paragraph to this section – the unusually high concentration of income and wealth at the top in Latin America – in one way may seem to make the task of fiscal redistribution easier since it means that a progressive income tax, or a wealth tax, can be viewed as a very limited instrument affecting a few people, rather than having to tackle the many problems of mass income taxation once it extends beyond a simple tax on wages. As Tanzi (1966) noted many years ago, most of the conventional arguments as to why personal income taxes are difficult to implement in developing countries fail when it comes to taxing the rich in Latin America: there are not many of them, they can certainly comply with such a tax, and so on.

In the end then, the role played by income taxes in Latin America seems to come down largely to a simple political calculus: can the obvious opposition of the wealthy elite to such taxes be overcome? It was overcome in most of the developed world over the last century, though not easily nor quickly: why should Latin America be different? The rich can block such efforts in many ways, of course: they can block progressive legislation from being passed in the first place; they can introduce incentives and provisions to blunt its effects (doing so, of course, in the name of the “national interest”); they can corrupt the administrative process or use their resources to mute and delay it in many legal ways; or they and their resources can flee the jurisdiction. All this and more goes on in most Latin American countries, of course, and has done so for many years now. Are matters any more likely to be changed in these respects now that the fiscal pressure on the rich has been so obviously lessened in most developed countries also?55

Taking all these factors into account, what can be said about the role of income taxes in Latin America?

• First, even if the only objective of such a country is economic growth, there is a clear case for a tax on business and especially corporate income, if only to collect a fair share of the revenue that multinational and large domestic businesses derive

55 Krugman (2002) provides a nice discussion of the current pressure to eliminate the estate tax in the US – a story paralleled almost exactly by the experience of Canada some 30 years ago as told in Bird (1978a).
from economic activities in that country (Bird, 2002). It is of course true that by taxing corporations differently, and usually more heavily than other forms of business, governments tend to discourage, at least in principle, the operation of businesses in corporate form. Still, the fact that most major businesses all over the world operate in corporate form despite the prevalence of corporate income taxes suggests that the corporation remains in general the best available vehicle for mobilizing large amounts of capital for business purposes. Since corporations are the engine of development in all modern societies, a tax on corporations is in effect a tax on the modern, growing sector of the economy. Countries need to tax that sector both to secure the revenue they need to meet expanding expenditure demands and also to ensure that those who benefit most from development pay their fair share. But they must also ensure that corporate taxes are not so high as to discourage growth. In general, the best approach – now almost universally adopted in major Latin American countries – is to impose a moderate, stable tax on all corporations.56

- As for personal income taxes (as distinguished from general wage levies such as those imposed in many countries for social security purposes), their principal objective is presumably largely to mitigate, at least to some degree, inequalities in income and wealth. Many have also noted the desirability of expanding the base of consumption tax to encompass more services, in part to reduce regressivity. Unfortunately, it has often proved exceedingly difficult to include many services, especially those consumed disproportionately by the rich, in the base of taxes such as the VAT, so at the very least some degree of progressivity in the personal income tax may also provide a useful offset to the likely regressive impact of the consumption taxes on which the revenue systems in most lower and middle-income countries depend. In such countries, for the most part personal income taxation should likely have a “threshold” – the level of income at which the tax begins to apply – well above average income levels. Moreover, to check tax avoidance, it would likely also be wise to keep the top marginal rate of the personal income tax fairly close to the rate of the corporate income tax., which means that it is not likely to be all that high.57

In the end, of course, just how much, and how, the rich are taxed remains essentially a domestic political choice. As noted in Section 11 below, the opening of capital markets, combined with weak international tax enforcement capabilities, makes it harder to tax the rich extremely heavily. But there is no doubt at all that most Latin American countries could not do more than they now do in this respect, if they wanted to do so. Similarly, most countries could do more to tax the poor less (as well as to tax the middle group both more fairly and more efficiently). The bottom line is that countries get

56 Harberger (2003) suggests that the CIT should be “integrated” with the PIT, largely on distributional grounds. As noted earlier, I am somewhat less convinced of the merits of corporate-personal tax integration (see Bird, 1987) but this is not the place to go into this rather technical issue.

57 Although a good case can also be made on distributional grounds for some form of tax on estates and inheritances, as argued in Bird (1978), with examples for Bolivia in Musgrave (1981), this tax is so far out of fashion these days – and so easy to evade, especially in an open economy -- that it is probably not worthwhile to go into this matter in detail here.
the tax systems those who run them want, and those who run most Latin American countries have clearly not wanted a very redistributive tax system. There is no escaping the underlying political reality and no fiscal short cut to a more egalitarian society.

10. Back to Politics

The central social and economic problem in many Latin American countries is inequality. On the other hand, the key, and related, governance problem is lack of accountability. A good tax system is critical to the solution of both problems. Reforms that link taxes and benefits more tightly for example, such as decentralization and more reliance on user charges, and motor fuel and vehicle taxes, may help accountability. From the perspective of redistributive policy more generally, undoubtedly the most important function of the tax system in most countries is simply to provide (non-inflationary) funding for pro-poor spending programs. In addition, however, as suggested in Section 8, it is not hard in most countries to think of some ways of “untaxing” the poor, e.g. setting higher thresholds for certain taxes or charges (e.g. lifeline utility services) or granting certain exemptions from VAT. Direct relief may be more efficient, but it may also not be easy to implement effectively.

As noted in Section 9, it is equally easy to think of ways to tax the rich more effectively, through indirect means such as taxes on vehicles as well as through such direct means as taxes on income and wealth (land, estates). Even a badly administered wealth tax, for example, if it can be imposed on the richest 1-2% of society may sometimes be worthwhile not only in symbolic but also in actual terms (e.g., a 1% tax on wealth that yields on average a 5% return is equivalent to a 20% tax on that return). Many assets of the wealthy are underutilized: such taxes may encourage at least some of their owners to put them to socially better use. Similarly, many incomes of the rich may reflect “rents” secured through political connections or monopolies and thus offer a potentially economically costless source of revenue. On the other hand, as IDB (1998) stress, attempts to impose unduly redistributive taxes may backfire so that countries end up with smaller and less redistributive public sectors, and, as Harberger (2003) notes, even the most redistributive tax will not in itself have any much effect on income redistribution.

What is actually done with respect to any of these matters will of course be determined in the political arena. Countries in the LAC region vary enormously in the effectiveness and nature of their political systems. Some may be close to “failed states” in which institutions are so ineffective that it does not matter much what they attempt to do --it will not work. Others may be “developmentalist” (as in the early CEPAL model) and want to use their fiscal systems largely as interventionist instruments. Still others

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58 As Bird and Miller (1989a) show, in developing countries, contrary to popular rhetoric, most user charges are progressive in their incidence. The property tax, and some local business taxation, may be considered to be “generalized user charges” if properly designed and implemented (see Bird, 2003).

59 Bird (1978) explores this issue in detail.
may be of a more laissez-faire disposition. Some may be more populist, some more elitist, some more predatory.

The dominant policy ideas in different countries – about equity and fairness, efficiency, and growth – like the dominant economic and social interests – capital, labor, regional, ethnic, rich, poor -- and the key institutions – political (democracy, decentralization, budgetary) and economic (free trade, protectionism, macroeconomic policy, market structure) -- all interact in the formulation and implementation of tax policy. This changing interplay over time affects the level of taxation, the structure of taxation, and many of its critical details such as the progressivity of rates.

Indeed, taxation is one of the major battlegrounds on which we can see the working out of these complex forces. Suppose, for example, that both the public at large and the elite want changes, for different reasons. The elite, which even in a democracy can manipulate the state to a considerable extent as long as it does not alienate the public too much, can use the public concern as “cover” to achieve its own ends. Consider, for instance, the sad story of property taxation in North America. Once seen as the bulwark of local democracy and accountability, this tax has, over time, come to be considered by the public at large as regressive and unfair (Youngman, 2002), thus fostering elite interests in lowering the tax burden on an asset base they disproportionately control. The spillover of the anti-property tax rhetoric into even more unequal societies to the south has made it even more difficult to institute not only the kinds of specific land taxes that might contribute to land reform (Dorner, 1992) – although one might rightly be skeptical about the effectiveness of such measures in any case (Bird, 1974) -- but even the low-rate effective property taxes needed to finance local governments.

As Weisman (2002) shows, progressive taxation came into being in the US over a long period from the Civil War to the First World War, reflecting changing perceptions of social and economic reality. Subsequently, as Piketty and Saez (2001) suggest, there is some evidence that “...steep progressive taxation, by reducing drastically the rate of wealth accumulation at the top of the distribution, has prevented large fortunes to recover fully yet from these shocks [of the depression and the Second World War].” More recently, as Krugman (2002) notes, the days of the “golden rich” may be returning. Steinmo (1993, 2002), Blyth (2002), Alesina and Angeletos (2002) and Lindert (2002) in different ways have recently explored the workings of similar forces across a variety of developed countries (see Box 3). There remains, of course, a great deal that we do not understand about these complex matters. What seems clear from the work done to date on the political economy of taxation, however, is that while taxes definitely matter in both economic and political terms, they are more driven by, than drivers of, social and economic conditions.

Viewed from this perspective, Latin America has yet to experience even the earlier parts of the cycle that produced the (more or less) redistributive fiscal state now found in developed countries – the long preparatory period during which the idea of the desirability, and even necessity, of a more effectively progressive tax system becomes so established that, when the time is ripe, such taxes are in fact implemented. Instead,
bypassing as it were this “egalitarian” period, some countries in Latin America seem to have moved directly from the “feudal” inequality of land-based maldistribution to the modern era of capital-based maldistribution. Doreen Warriner (1969) once said, despairingly, that Latin Americans did not seem to know what a good land reform means – probably because they had never seen one. Equally, one might perhaps speculate that, in most countries of the region, as Engerman and Sokoloff (2001) almost – but not quite - say, most people do not really know what moderate or justifiable inequality might mean, since they have never seen it.

Governments in many Latin American countries are in dire straits. Even those who have reached relatively safe harbors politically, and have a certain degree of legitimacy and stability, almost always feel – often correctly – that they are in an economically precarious situation. The budget is politically and economically constrained. Life is difficult. Nothing can be done. All this may be true to some extent, but it is also both too much a counsel of despair and too easy a way out. Even in the most hopeless situations, something usually can be done to improve matters. No doubt there will be much dispute over what should be done to improve tax systems. Unless and until an adequate degree of political consensus on what should be done is achieved, however, no significant tax changes are likely to be made.

As Lledo, Schneider, and Moore (2003, p. 47) stress, much of the problem in Latin America is that most countries lack “…an (implicit) social contract between governments and the general populace of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world.” What needs to be added to this bleak but accurate assessment is that history tells us that such principles generally do not get “embedded” either painlessly or quickly. The specific substantive suggestions that Lledo, Schneider, and Moore (2003) make to improve matters – more use of income taxes, better VAT administration on a broader base, more attention to subnational taxation, more attention to informal activities and environmental aspects of taxation, closer ties to expenditure policy, and so on -- are of course already the stuff of countless existing reports. Who can argue?

The real question, as noted in section 6 (with respect to Gemmell and Morrissey (2002)) is, why has so little been done? From this perspective, by far the most important conclusion of Lledo, Schneider, and Moore. (2003) -- which is also in many ways the main point of the present paper -- is their final recommendation “to improve political institutions in ways that enhance legitimacy and capacity.” In other words, there can, so to speak, be no good taxation with good representation. The trouble with this truism, alas – and it is a truism – is that history suggests that in all too many cases there has seldom been either good taxation or good representation without first going through a period of bad taxation which, in Hegelian fashion, called forth forces that in the end improved both representation and taxation. If this is so, then perhaps Latin Americans are luckier than they think, since they have a lot of bad taxation to begin with.
11. Where to Next?

More seriously, in Latin America as elsewhere a key ingredient of a sustainable tax policy and hence a sustainable state is a judicious balance of efficiency, both static and especially dynamic, and equity, both currently and in intergenerational terms. Current distributional concerns may occasionally in some countries dominate policy to the detriment of the other three critical ingredients. Many economists have expressed this worry about many tax systems. Fewer, perhaps, have noted that, unless a tax system is perceived and accepted as “fair” by most of those subjected to it no state is ultimately sustainable. It is this problem that seems to resonate most in Latin America today.

A key question facing Latin American policy-makers today is whether the increased inequality and stumbling growth of recent years demonstrate that the market route has been tried and failed, as many seem to believe, or whether instead it can be argued that rather than real reform what most of Latin America has experienced may better be characterized as half-hearted attempts at reform in a context of continuing interventionism? Can half a loaf be worse than none? Should Latin America give up and go back to the Cepalista 1960s, or should it persevere on what some call a “neo-liberal” path? Or, alternatively, as this paper suggests, should it strive for a more balanced path, paying more attention to equity concerns but in a “growth-facilitating” way?

The Key Questions…and Answers

To sum up, the key questions about taxation and inequality in Latin America may be briefly asked, and answered – of course in much too general a fashion to be applied as is to any particular country -- as follows:

- **Have** taxes reduced inequality in Latin America? Not much, if at all.
- **Can** taxes reduce inequality? In principle, yes. Taxes can redistribute income, but not, on their own, very much, and, unfortunately, perhaps less so the more unequally income is distributed.\(^{60}\)
- **Should** taxes be used for this purpose? Latin American countries have to answer this question themselves, of course. If they are concerned mainly with alleviating poverty, the answer lies on the expenditure, not the tax, side of the budget. But if they want to create a more inclusive, and hence presumably more sustainable,

\(^{60}\) The situation differs considerably from country to country. In Canada, for example, where the Gini coefficient for the distribution of market income was 0.424, it was only 0.316 after taking the effects of direct redistributive policy (taxes and transfers) into account (Sharpe, 2003). Although two thirds of this reduction was due to transfers, one-third was due to taxes. In other words, market income inequality was reduced by taxes by 9.6 percent in 2000, and by a further 18.3 percent by transfers. In a recent U.K. study (cited by Stern, 2003, p. 16, n.4) transfers in that country reduced the Gini coefficient from 0.53 to 0.38. In contrast, direct taxes reduced the Gini only to 0.35 and indirect taxes were estimated to increase it to 0.40, so the net effect of the UK tax system on distributional inequality was actually negative. As mentioned earlier, Engel, Galavatic and Raddatz (1999) show that the amount of redistribution attainable through even quite radical fiscal reforms in Chile is extremely limited.
state, the rich of Latin America will almost certainly have to accept higher taxes than they are accustomed to pay.

- **How can taxes reduce inequality?** The answer is not rocket science. Cut taxes on the poor. Raise taxes on the rich. But be very careful exactly how you do it, and pay very close attention to what is going on in the middle! Get the political process as “right” (inclusive) as one can, and what results is then, by definition, the best that can be done. Perhaps the most important point for those concerned primarily with income redistribution is that the bigger a government is, the more likely it is to be able to effect redistribution. Of course, bigness alone does not guarantee success. As IDB (1998) notes, the distorting costs of taxation on one hand and the ineffectiveness of much allegedly distributive expenditure on the other can more than cancel out any positive effects from a larger fiscal pie.

The more important message is probably that the best tax system is the one that produces the most revenue in the least costly and distorting way. A broad-based VAT, and not a steeply progressive income tax, is thus the way to go, probably supplemented by more attention to taxes on land and property, to good user charges, and to taxes on motor vehicles and fuel.

Finally, consider the international context of tax policy today. Countries in Latin America, as elsewhere, have been exposed to the winds of global change. Most countries no longer have the luxury of designing their tax systems in isolation. The overworked word “globalization” has been used to mean anything from an increase in mobility of business inputs, primarily capital, across regions to changes in consumption and production patterns so that national borders have reduced significance. But the general idea is clear -- a loss of sovereignty, and, not least, a loss of tax sovereignty.

**Does Globalization Matter?**

With the dramatic reduction in trade barriers over the last decade, taxes have become a more important factor in location decisions. There is increased tax competition for portfolio investment, qualified labor, financial services, business headquarters, and, most importantly for developing countries, foreign direct investment. Tax differentials thus matter more than before, so that countries with tax systems that differ substantially from those of its neighbors, may gain (or lose) as a result.

In addition, with increased financial innovation, labels are losing their meanings. Lawyers and investment bankers can with relative ease convert equity to debt, business profits to royalties, leases to sales, and ordinary income to capital gains--or the other way around. Much of the traditional tax regime for taxing cross-border transactions rests on a stylized set of facts: (i) small flows of cross border investments; (ii) relatively small numbers of companies engaged in international operations; (iii) heavy reliance on fixed assets for production: (iv) relatively small amounts of cross-border portfolio investments.

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61 For an example of the importance of tax details, see Lindert (2002) on the different impact of similar tax rates on different groups of workers.
by individuals; and (v) minor concerns with international mobility of tax bases and international tax evasions. But all this has now changed, at least to some degree.

What does all this mean for tax systems in Latin America?

• First, there is continued pressure to reduce trade taxes. WTO membership requires significant reductions in import and export taxes.
• Second, there will be increased pressure on corporate income tax revenues. Over the last decade there has been a major change in many business operations with the disaggregation of production resulting in different operations in different countries. The increased share of value-added due to services and intangibles makes it harder to locate the source of corporate income and thus harder for countries to tax corporate income. Increased intra-company trade also makes it easier to avoid or evade taxes.
• Third, there will also be increased pressure on individual tax revenues. Increased mobility of capital makes it harder to tax income, especially as it becomes easier for individuals to earn income outside of their country of residence. It may also be harder to tax labor income, as labor becomes more mobile, as traditional employer-employee relationships evolve into independent contractor status, and as owner-managers convert labor income into capital income.
• Finally, there will also be pressure on VAT revenues. Much has been written about the challenges posed by electronic commerce on both the income tax and VAT base. Improvements in technology allow increased sales without the seller having a physical presence in a country, as well as increased use of digitized products that make collecting taxes on such products more difficult.

All in all, the taxman’s life is not becoming any easier in Latin America, or anywhere else. Nonetheless, despite the increasingly tight international economic constraints on tax policy, it is still undoubtedly the case that no country in Latin America is anywhere near the limits of what it can do, if it wants to, to impose a fairer (or, for that matter, a more efficient) tax system.

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62 For a detailed discussion, see Bird and McLure (1991).
63 It is unlikely, however, to make it impossible: see Lin (2003) for further discussion.
References


