European Journal of Political Economy xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Explaining changes in tax burdens in Latin America: Do politics trump economics?

Mark Hallerberg [a], Carlos Scartascini [b,*]

[a] Hertie School of Governance, Berlin, Germany
[b] Research Department, Inter-American Development Bank, Washington, DC, USA

ARTICLE INFO

Article history:
Received 12 November 2015
Received in revised form 28 June 2016
Accepted 5 July 2016
Available online xxxx

JEL classification:
P11
H2
D72

Keywords:
Tax reform
Elections
Crisis
Political economy
Latin America

ABSTRACT

This paper examines whether elections, which are generally held on fixed dates, and banking crises explain the timing of tax reforms and the allocation of the additional tax burden. Using an original fine-grained data set of tax reforms, the paper finds support for the role of these two sources of variation. In particular, the probability of reform is higher during banking crises. During electoral periods, increasing taxes becomes highly unlikely, even if the government is facing financing problems. Interestingly, politics seem to trump economics: banking crises do not affect the probability of having a reform during electoral times. Moreover, the presence of an IMF program affects the tax instruments chosen: countries with a program increase the value-added tax, while those without raise the personal income tax. Finally, the ideology of the president does not explain who bears the additional tax burden.

1. Introduction

An issue economics has considered for at least half a century is why low-income and developing countries do not tax more Kaldor (1963), as cited in Bird et al., 2008. Indeed, governments in such countries may have several reasons why they may *want* to pass legislation to increase revenues, and there is a growing policy literature that calls for developing countries to increase their "tax effort" (Le et al., 2012) that harkens back to an earlier literature (Musgrave, 1969). There are political reasons for why these governments may want to increase tax burdens; for example, they may face increasing demands for redistribution (Hart, 1990). Public initiatives that cost money, be they improved infrastructure projects or higher salaries for teachers, require funding. Own sources of revenues may be especially important in developing countries where access to world capital markets is limited, which in turn restricts the ability of governments to rely on large-scale deficit financing (Kaplan, 2013). During banking crises in particular, the state is usually the main source of funding to address both the causes of the crisis in the banking sector and the consequences of the crisis for the general economy. It also has to compensate for the drop in revenues that the crisis entails (Reinhart and Rogoff, 2009).

* Corresponding author at: Research Department, Inter-American Development Bank, 1300 New York Ave, NW, Washington, DC 20577.
E-mail address: carlossc@iadb.org (C. Scartascini).

http://dx.doi.org/10.1016/j.ejpoleco.2016.07.004

Countries in Latin America are part of that group of developing countries that collect less revenue than would be expected given their level of development and socioeconomic structure: in spite of significant progress in terms of increasing tax revenues in the last two decades (almost 3 percentage points of GDP) a recent study suggests that the tax pressure gap for Latin America is still at 2.3 percent of GDP (Corbacho et al., 2013; Eclac, 2013). This means that, for its level of development, tax revenues should on average be >2% of GDP higher than they currently are.[1] Interestingly, the tax gap is not constant across taxes. VAT revenue levels are similar to those in OECD countries. In contrast, the collection of income taxes—and in particular, personal income taxes—is very low (Corbacho et al., 2013; Eclac, 2013). Differences like these are not only common across taxes but also across countries. While some of the countries in the region are collecting revenues beyond what would be expected (e.g., Brazil collects >5 percentage points of GDP than would be expected), the tax gap for other countries is large (e.g., Mexico collects <10 percentage points of GDP of what is expected; see Corbacho et al., 2013). These differences can be traced back to the number, type, and direction of reforms each country has decided or been able to implement. There is a positive correlation between reforms and revenues, which is strong for reforms to the major taxes, such as to the personal and corporate income taxes as well as to the value-added tax (Focanti et al., 2016).

In this paper, we make what may at first seem like a counterintuitive argument if one considers standard prescriptions for what governments should do during economic downturns—we contend that reforms that increase revenues are more likely during banking crises.[2] These are periods where economic growth contracts and where a standard policy prescription would be to stimulate the economy. However, in the case of countries that are financially constrained from raising funds internationally and affected by a severe reduction in revenues, and where the government is the only one in a position to resolve the banking crisis, policy prescriptions have to react to fiscal reality. This reaction has not only been true for Latin America, as we argue, but there is evidence of a similar policy response by U.S. states in the 1930s, and many countries in the 2008 crisis, as we discuss later.

Looking at specific tax instruments, the increase is especially evident for value-added taxes.[3] There are plenty of reasons to make the VAT the instrument of choice. First, the VAT commands a larger share of revenues in the region, it is easier to control and collect, and the effect of a rate increase tends to be more immediate than for income taxes. Second, increases to the VAT may be easier to implement politically. It is harder for voters to see the tax increase (e.g., fiscal myopia): the tax is included in the prices of goods and services and those who pay ultimately pay the tax, consumers, are not those who deal with the tax authority. It is also less likely that consumers who pay a bit more VAT collectively organize to oppose it than a few very large corporations who may organize to oppose a CIT increase. Third, increases in the VAT would have a lower impact on the sector under distress (banking sector) than increases to other taxes (Hall, 1996).[4] For many of these reasons, including the search for efficiency in the tax system, increases to the value-added tax were often included in the memorandums of understanding with the International Monetary Fund as a conditionality for financial support. We explore this connection in detail below, and we find empirically that countries under an IMF program during a banking crisis were more likely to increase the value-added tax while countries that were not under a program were more likely to increase the personal income tax. Reductions in the marginal top rates of the income tax were usually preferred by the IMF for increasing tax neutrality (IMF, 2013).

While banking crisis had a commanding role on leading reforms, political considerations have been even stronger at the moment of passing reforms. Even in the midst of a crisis, governments do not raise taxes before elections. Therefore, banking crises seem to motivate reform in non-electoral years, but not during electoral years.

To evaluate our argument, we make use of a unique database of tax reforms for Latin America that focuses on the date of actual legislation that changed the tax code, which allows us to evaluate the relative burden of the reforms.[5] Our database indicates when countries passed reforms, which ones intended to raise or decrease revenues, which taxes were affected, and whether the change introduced modified the rate, the base, or other aspects of the law. It covers the time period 1990–2004, when all the countries but Cuba and Haiti, which are not included in the analysis, had become full-fledged democracies.[6] These data allow us to narrow our focus to the intent of governments and the actual political feasibility of moving ahead with

[1] The tax gap is computed by taking into account tax revenues controlling for economic development, the populations age distribution, openness of the economy, the levels of self- employment, and the share of revenues coming from natural resources (Corbacho et al., 2013).

[2] Carciofi et al. (1994: ch. 9) show that a similar trend took place during the eighties in many countries in Latin America. Tax reforms were responses to the economic and fiscal situation of each country and their design was affected by the severity of the situation.

[3] If one considers changes in political control in Latin America over the period, where executives as a group moved leftward, this result is potentially counterintuitive, as one would expect a greater reliance on potentially more progressive income taxes. This trend is, at least when looking only at partisanship and tax composition, a puzzle when compared to Eastern Europe and in the former Soviet Union in the same time frame. In that region, it was predominately right-wing parties that pushed for "flat taxes" that lowered PIT and CIT rates and raised VAT rates to the same level. In places where the right came to power, these types of reforms were implemented (Appel and Orenstein, 2012).

[4] Many of these considerations, particularly the fact that the VAT is easier to collect and easier to hide from the public, have fueled the debate in the US, as summarized in a 2016 Wall Street Journal article. See http://www.wsj.com/articles/should-the-u-s-adopt-a-value-added-tax-1456715703.

[5] The database can be downloaded from http://www.iadb.org/en/research-and-data/publication-details,3169.html?pub_id=IDB-DB-111. See Focanti et al. (2013) for sources, definitions, and coding criteria. The list of the 18 countries included in the sample is available in Table 1.

[6] Every country-year except Peru in 1992 is considered democratic according to the Polity 4 database. As we discuss later, de jure and de facto differences existed and we exploit them.

Please cite this article as: Hallerberg, M., Scartascini, C., Explaining changes in tax burdens in Latin America: Do politics trump economics?, European Journal of Political Economy (2016), http://dx.doi.org/10.1016/j.ejpoleco.2016.07.004