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Taxation, Social Cohesion and Fiscal Decentralization in Latin America

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Abbreviations

ECLAC	UN Economic Commission for Latin America and the Caribbean
ECLAC-ILPES	ECLAC-Instituto Latinoamericano y del Caribe de Planificación Económica y Social
EU	European Union
FGFF	First Generation Fiscal Federalism
GDP	Gross Domestic Product
ICT	Information and Communication Technologies
IDB	Inter-American Development Bank
MDG	Millennium Development Goal
ODA	Official Development Assistance
OECD	Organisation of Economic Co-operation and Development
SGFF	Second Generation Fiscal Federalism
US	United States
VAT	Value-Added Tax

1 Introduction

Social cohesion in modern, complex societies hinges upon the capacity of states to supply the necessary means for the symbolic and material integration of its citizens. Although in an increasingly globalized and urbanized world states are not the only arena for collective action and integration, they exert without any doubt a decisive influence on the living conditions of large parts of the world's population.

In order to fulfil their functions, states need money. They obtain money through different channels – mainly, by charging *fees* for services or *royalties* for the extraction of natural resources, by receiving *contributions* to public social security, by obtaining *credits* from banks and international financial organizations, by issuing money (*seigniorage*), by receiving a share of the *profits* of public enterprises (e. g., mining companies), by *selling* public enterprises or assets, by receiving *official development assistance* (ODA) – and by levying *taxes* (including *customs duties* on foreign trade). Usually, revenues from fees, social security contributions and taxes lumped together constitute what is called the "tax pressure" or "tax burden", often expressed as a share of the gross domestic product (GDP) or of total public revenue.

Taxes, ODA and rents from natural resource extraction are the dominant income sources for contemporary states (Moore 2007, 10–14). In general terms, the richer a society, and the more equitable the social distribution of wealth and income, the more revenues are obtained through taxation. For instance, in 2005 the average tax yield (including contributions to social security) of the Organisation of Economic Co-operation and Development (OECD) countries amounted to 36.4 % of the GDP, while the Latin American average stood at a mere 17.1 % (Cetrángolo / Gómez Sabaini 2007a, 8).

Why is it that richer and more equitable societies pay more taxes?

To begin with, in richer societies the state is simply more expensive, even in relative terms. Since competence and salary levels are higher, public employees cost more. Also, the range of goods and services provided by the public sector is usually broader than in poorer countries – especially with respect to labour-intensive services such as public security, education or health. In addition, richer societies invest more in public infrastructure, and innovation or modernization cycles tend to be shorter compared to poorer countries.

Another argument usually brought forth to explain different levels of taxation refers to *capacity:* States in poorer countries do not obtain but a fraction of the *potential* tax revenue, because their tax administrations lack the capacity to enforce laws and regulations on citizens and the private sector. This is especially true for the subnational levels of government. For instance, the public sector may not have the capacity to obtain the necessary data on land use and value, or on financial transactions. Also, there may be a lack of monitoring capacity with respect to economic activity. Another aspect could be that public entities lack the capacity to effectively sanction tax evasion, even if they are able to detect it. In some countries, tax collection remains low because of extralegal payments (corruption) or bad recruitment policies (clientelism). Finally, taxing capacity may be affected by political pressure exerted by powerful groups.

Often, the economic structure is cited as an influencing factor for taxation. For instance, most Latin American countries are characterized by a highly dualistic private sector, composed of a small group of big and modern companies, on the one hand, and a large number of microenterprises with low productivity, on the other. This dualistic structure has been deepened in the course of market liberalization over the last two decades, driving growing parts of the economy into informality. At the same time, the highly unequal distribution of wealth and income in most Latin American countries leads to a polarization of consumption patterns and markets. Under such conditions, the tax base remains small, and those who could (and should) pay taxes have considerable leverage to avoid payments. Also, the lowering of tariffs in the wake of market opening has led to decreasing revenues from customs duties on international trade.

Still another explanatory factor for low taxation levels may be found in the fact that many regimes find it easier to obtain revenues from rents, development aid, or the inflow of foreign capital than from taxes paid by citizens. This is a *moral hazard* problem[1] that has been discussed in a number of academic and public debates, for instance, on rentier states or on the relation between development aid and domestic sources of public revenue.

Finally, and perhaps most importantly: Even if it may sound odd, it can be argued that OECD citizens are simply more inclined to pay taxes than Latin American citizens. This is because the *legitimacy* of taxation is higher in OECD countries. Legitimacy rests on the acknowledgment that a political order serves the public interest. For the average OECD state, it is easier to substantiate that claim than it is for the average Latin American state, due to three basic reasons: First, the tax system is fairer: the *tax base*, i. e. the percentage of those who actually pay taxes, is much broader, and public finance in total is less regressive in the OECD than in Latin America. Second, financial management is based on procedural legality and is more transparent than in many Latin American countries. Third, compared to Latin America the quality of public goods and services "purchased" by the taxpayers is higher, and "government waste" through corruption, embezzlement or bureaucratic red tape is lower in the average OECD setting.

In the light of these observations, it appears obvious that the question why some states collect more taxes than others is not merely a problem of per capita income levels or technical capacity. Rather, it is a problem of *systemic governance,* which includes issues of political constitution, public administration, bargaining and decision-making. If levels of taxation, per-capita income and good governance are closely connected, as aggregate data suggest,[2] there is no point in using ODA or credits as a leverage to coerce developing states into raising taxation levels up to OECD standards. Instead, raising taxes should be seen as but one element of a much broader effort geared towards increasing social cohesion, the quality of public service provision and, ultimately, legitimacy.

In the following chapters, two interrelated arguments will be discussed: First, taxes are a key element of *social cohesion* – not only because they provide the means for social policies and public goods provision, but also because the tax regime has important repercus-

1 The term "moral hazard" refers to situations where individual or collective actors are able to externalize the costs of their actions to third parties and thus do not have to bear the full consequences of their actions.

2 For instance, see Easterly et al. (2006); Perry et al. (2006).

sions on growth and competitiveness. Further, taxes are the expression of a social contract, a fiscal pact, which carries a promise of political and social inclusion. Any attempt to strengthen or broaden this fiscal pact has to take the legitimacy of taxation into account (Chapter 2).

Second, it can be assumed that citizens will be more willing to acknowledge the necessity and "rightfulness" of taxation if there is a close relationship between taxes and the provision of public goods and services. *Fiscal decentralization* can make a significant contribution to closing the gap between taxation and public goods provision. In addition, it may be a key instrument for the fundamental task of broadening the tax base (Chapter 3).

In most Latin American countries, the taxation basis of the social contract is missing. Not only are actual tax levels low, but also does taxation depend highly on indirect taxes, especially the value-added tax (VAT), whereas direct taxes are levied to a much lower degree. As a result, the upper strata of society are spared from contributing their fair share to the financing of public goods and services, while benefiting disproportionately from the goods and services provided by the state (Chapter 4).

Even though the picture of public finance in Latin America shows some notable improvements in recent years, there is still a pressing need for further tax reforms. Policy-makers as well as donors and international organizations are well advised to take the taxation side of social cohesion into account. Above all, they should promote efforts to broaden the tax base and to strengthen revenue generation at subnational levels of government in order to change the prevalent culture of tax evasion and avoidance (Chapter 5).

2 Taxation and Social Cohesion

"Social cohesion" is a multi-faceted term with connotations of trust, political legitimacy, an equitable provision of public goods, material well-being and cultural reproduction. The term combines an "objective" dimension – the material and symbolic mechanisms responsible for achieving and maintaining social inclusion – with a "subjective" dimension – the perception of belonging to a collectivity, the attitudes towards the mechanisms of inclusion provided by the collective order, and the predisposition to integrate oneself into that collectivity. There are different levels of social cohesion, as social actors belong to different collectivities, from micro-level groups (family or kin, local communities, etc.) to macro-level entities such as nation-states. In this paper, the term will be used in this latter, macro-level understanding, because the basic unit of analysis is the nation-state.

Measuring social cohesion

Due to its complex nature, there is no single measure for social cohesion. Many contributions to the debate focus on the "objective" part of the term. For instance, the European Union (EU) uses 21 indicators in four categories (income, employment, education and health) to measure social cohesion (European Commission 2005).

In contrast, recent publications of the UN Economic Commission for Latin America and the Caribbean (ECLAC) and the Inter-American Development Bank (IDB) assume a broader view. ECLAC distinguishes "gap indicators" (income and poverty, employment, education, health, housing, pensions, digital divide) from "belongingness indicators" (multiculturalism, trust, participation, expectations and solidarity) (ECLAC 2007b, 15–45).[3] The first dimension relies on objective indicators, while the second dimension is based on data from opinion and perception surveys.

The IDB has created a "Social Cohesion Index" based on two dimensions: "distribution of opportunities" and "social capital". The first dimension assesses the socioeconomic structure by looking at poverty, income distribution, the size of the middle class, the distribution of access to education, and intergenerational mobility. Also, it considers the political structure, taking as indicators equality under the law and participation. The "social capital" dimension measures positive externalities (involvement in organizations, trust, fiscal capability) along with negative externalities (labour conflicts, crime victimization, homicide rate) (IDB 2006, 12).

As can be seen, the IDB index contains a measure called "fiscal capability".[4] Interestingly enough, it is subsumed under the "social capital" heading. However, apart from a number of methodological questions concerning the indicators,[5] it is by no means clear in which sense fiscal capability should be considered a subordinated function of social cohesion, let alone social capital. As will be shown below, the relation between fiscal capability and social cohesion is much more complex than envisioned by the "Social Cohesion Index".

Although difficult to measure, however, social cohesion is commonly acknowledged as an important factor for development:

> *"Societies that boast higher levels of social cohesion provide a better institutional framework for economic growth and attract investment by offering an environment of trust and clearly defined rules (...). Moreover, long-term policies that seek to level the playing field require a social contract to lend them force and staying power, and such a contract must have the support of a wide range of actors willing to negotiate and reach broad agreements. In order to do so, they must feel themselves to be a part of the whole, and they must be willing to sacrifice personal interests for the good of the community.*"(ECLAC 2007b, 19)

3 In a similar fashion, Easterly et al. (2006, 4–9) distinguish "direct measures" of social cohesion (civic organization and participation, trust) from "indirect measures" (income distribution, ethnic heterogeneity, institutional quality).

4 See IDB (2006, 39). The measure consists of two separate indicators: (1) an effectiveness indicator (the difference between the real level of tax revenues as a percentage of GDP and the level of tax revenues as a percentage of GDP which would be predicted given the country's level of development), and (2) a proxy for tax system efficiency, based on a question to business leaders from the Global Competitiveness Report ('The tax system in your country is: 1=highly complex and distortive of business decisions, 7=simple and transparent.'). There is no indicator that measures expenditure efficiency or effectiveness.

5 Comparing actual and "potential" levels of tax revenue may provide important clues for the future direction of fiscal reforms, but it is too rough a measure for the assessment of "fiscal capability". For example, Peru has registered high growth rates in its corporate income tax revenues without major changes in its fiscal capability. Instead, the state benefits from higher profits of the private mining companies – a result of the current *bonanza* of global commodity prices. In Chile and Mexico, two other raw material exporters, the state benefits too, but the effect on *tax revenues* is considerably weaker because important parts of the extractive industries are in public hands. Likewise, even if the opinion of business leaders concerning the simplicity of the tax system were to be accepted as a proxy for efficiency, why should we assume that the market-friendliness of a tax system is an indicator for social capital?

From this point of view, there should in fact be a positive relationship between taxation and social cohesion: in societies with a high degree of cohesion, citizens are presumably more inclined to see the state as a vehicle of inclusion and a provider of public goods. Accordingly, they are more interested in a strong state that disposes of the necessary funds to fulfil its functions. Also, they are more willing to trust public authorities, and therefore tolerate taxes that are not closely linked to particular public services.

In contrast, members of societies with a low degree of cohesion tend to regard the state as an instrument of domination and self-privilegization of elites. In such an environment, citizens prefer to put limits to state intervention, which they regard as mostly detrimental to their interests. They do all they can to avoid paying taxes, preferring in any case those payments that are directly linked to a specific good or service they receive.

However, the view that social cohesion and taxation are positively associated would not remain uncontested. Instead, some approaches would argue that there is no clear relationship and that high levels of social cohesion may coincide with low levels of taxation, and *vice versa*. Others would point out that there could be at least a partial *trade-off* between taxation and social cohesion. The following paragraphs discuss these diverging views with reference to three dimensions of social cohesion: (1) the economic dimension: growth and welfare, (2) the social dimension: distribution and equity, and (3) the political dimension: legitimacy.

Growth and welfare

There is a broad consensus today that in complex societies with market economies growth may not be a *sufficient* condition for the promotion of social cohesion, but it is probably a *necessary* one. This is especially true for developing countries with a low degree of social cohesion. Periods of economic stagnation or recession in those countries are usually accompanied by heightened distributive conflicts or even tendencies of social disintegration. Only under very specific circumstances can social cohesion be preserved or strengthened in times of economic stagnation.[6]

Easterly, Ritzan and Woolcock have recently examined the inverse relationship, the effect of social cohesion on growth. They found evidence that, on average, “more cohesive societies have always grown faster than less cohesive societies” (Easterly et al. 2006, 10). This is so, because higher cohesion is associated with higher quality institutions, which in turn contribute to higher average growth rates.

At the same time, however, economic growth poses important challenges to social cohesion. Urbanization and migration, changing values and habits, newly emerging roles and functions, a growing polarization of wealth and income, and increased conflicts over scarce resources are just a few of the many aspects of growth that may affect social cohesion. Quite obviously, not any kind of economic growth is conducive to social cohesion. While social change is an inevitable companion of growth, it has to be managed in a way not to jeopardize the social foundations that make economic growth possible. To a considerable degree, this is a matter of public regulations and material policies. In performing

6 For instance, if a society is threatened by an external aggressor, it may stand united (or grow together) even under conditions of economic hardship.

these tasks, states first collect and then spend a part of the resources generated by economic activity.

Now, as far as neoclassical welfare economics and, for that matter, public choice theory are concerned, there is a clear trade-off between growth and taxation: taxes impose additional costs on entrepreneurial activity.[7] In doing so, they diminish profits and discourage investment, thus lowering the growth rate and future welfare levels of a society. Since tax regimes are never completely neutral in terms of economic activities, they lead to market distortions, which further affect growth rates and welfare levels (because investments are led away from the most profitable activity). Following this argument, taxes are only useful if they finance the production and provision of public goods and if the benefits generated by public policy surpass the costs in terms of reduced economic growth.

Another question relates to the appropriate level of tax rates. From the perspective of revenue-maximizing governments, the appropriate nominal level of taxation is reached at the peak of the so-called "Laffer curve", when every additional increase in tax rates would actually lead to lower revenue because of lower economic efficiency. Maintaining that current tax rates were actually *above* this peak, supply-side economists have insisted in the self-financing character of tax cuts in modern industrialized states. This view has gained much popularity in the 1980s, eventually leading to a general reversal of high nominal tax rates, not only in OECD but also in many developing countries (Sánchez 2006, 782).[8]

The appropriate level of taxation and the relation of tax costs to public policy benefits are typically among the most conflictive issues in politics – especially because both dimensions are so difficult to assess and because winners and losers on both sides of the taxation-distribution equation rarely coincide. However, since nobody would argue that states should levy no taxes at all, the question arises what kind of tax regime would be best suited to promote economic growth and, thus, social cohesion.

The answer is simple, although seemingly paradoxical. Following the *fiscal interest* approach, the most "market-preserving" tax regime is the one based on taxing economic activity:

> *"(G)overnment officials are biased toward market policies that generate more revenue within their fiscal system. When they capture revenue based on broad taxes on economic activity, they have incentives to provide market-enhancing public goods and to create new market opportunities as a means of increasing the fiscal proceeds generated by markets. If in contrast they raise revenue by selling monopoly rights, then officials seek to restrict markets."* (Weingast 2006, 23–24)

7 See Garrett / Wall (2005, 8–9) for a straightforward formulation of the argument: *"Entrepreneurship is an activity that requires investment, consumption and income generation to be successful. A sales tax reduces personal consumption, personal income taxes reduce the incentive to work, corporate income taxes reduce the incentive to start or expand a business, and capital gains taxes reduce the incentive to invest."*

8 The "Laffer curve" depicts the relationship between tax rates and tax revenue. At both extremes of the curve (tax rates at 0 % and 100 %), tax revenue will be equal to zero – in the first case because no taxes are levied, in the second case because every economic activity will be suffocated. The key question is at which point between both extremes revenues are going to peak. If tax rates are situated to the right of this point, lowering taxes will actually increase revenue. The most prominent adherents to this approach were the USA under President Reagan and the UK under Prime Minister Thatcher.

Hence, although there may be an immediate trade-off between growth and taxation, a broader view on economic competitiveness and its requirements indicates that state action is necessary to put growth on a sustainable basis. The main challenge consists in establishing a tax regime that reconciles the principle of market preservation with the needs of public finance. A market-preserving tax regime creates additional incentives for government authorities to implement market-friendly policies.

Distribution and equity

A key dimension of social cohesion lies in the access to basic goods and services, such as education, health, legal protection, housing, water, etc. Members of society who are denied access to these goods and services are considered poor. This is why more advanced measurements of poverty are based on goods and services baskets instead of absolute income levels such as one dollar a day.[9] Modern states are designed to assume a *primary distributive function* in order to guarantee minimum access to basic goods and services to the poor. This is especially important for those states where poverty levels are high and a large part of the workforce is employed in the informal sector, usually underpaid and without access to social protection.

But beyond that primary distributive function, citizens need to regard the social order they are living in as reasonably "just" or "fair", in order to feel fully included.[10] This has something to do with social mobility and equity. Mobility means that there should be no barriers to higher levels of welfare and social status other than individual merit, so that citizens can climb the social ladder thanks to their own effort. Equity means that the social distribution of wealth and income should enable the largest possible part of society to make a decent living out of their individual or household income.[11] Watching over mobility and equity can thus be considered the *secondary distributive function* of the state, and it is presumably just as important as the primary one.

Because of the relevance of mobility and equity, societies with high levels of cohesion are characterized by comparatively low levels of income polarization. Also, they try to shape the public revenue system so that the tax burden is distributed in a fair and equitable way. Usually, this implies the tax burden to be shared evenly between members of the same social strata, avoiding excessive subsidies in favour of particular groups or sources of income (*horizontal equity*). In addition, the richer sectors of society should contribute a larger share of their income than those who have less (*vertical equity*). Hence, an important dimension of the secondary distributive function of the state refers to taxation, more precisely: to the implementation of a broad-based progressive tax regime.

9 For instance, ECLAC (2007a, 11–12) uses national baskets to measure poverty levels in Latin America.

10 It is important to keep in mind that this argument is based on the notion of *citizenship*. Of course, in traditional, stratified societies, social actors may develop a feeling of inclusion even if they have no real chance of escaping their socially inferior position.

11 As an acknowledgement of the importance citizens attach to equity, the EU measures poverty referring to average income levels instead of absolute income or baskets, for instance by placing the income poverty threshold at 60 % of the median net equivalent income. In 2003, 13.6 % of the German population had an income below this threshold (Deckl 2006, 1183).

A majority of modern states has enacted legislation geared towards such a progressive tax regime. This is done mainly through the imposition of direct taxes, for instance personal income taxes with progressive tax rates, and by taxing property such as real estate and capital. Usually, however, the reality of tax collection diverges considerably from the norm in that the tax base is smaller and the actual progression lower than they should be.[12] Why?

There are of course a number of explanatory variables to be considered (such as the complexity of tax regimes or the requirements of tax administration), but it seems fair to assume that two reasons are particularly important. One reason refers to the fact that capital is much more mobile than other production factors, making it easier for capital owners to elude taxation, compared to owners of labour, land, etc. The other reason refers to the fact that "taxation is subject to severe common-pool problems", which means that from an individual perspective there are strong incentives to minimize contributions while maximizing extractions.[13] As the richer parts of society are usually more powerful and articulate than the rest, especially in heterogeneous societies, it is easier for them to exert influence on decision-makers and public sector managers and to obtain specific benefits through subsidies or tax exemptions. In defining (and defending) the appropriate progression, authorities have to take both aspects into account.

As has been said above, the benefits of the provision of public goods financed through taxes should be higher than the negative growth effect these taxes have. Now, if the tax regime is going to be progressive, this guideline faces additional challenges. For one, economic growth will be probably more affected by a progressive tax regime than by a proportional or regressive tax regime, because of the combined effects of lower growth and capital flight on investment. Also, resistance from powerful groups will be higher in a progressive tax regime. If authorities have little autonomy *vis-à-vis* particular interests (as in many developing countries), chances are high that tax progression has to be accompanied by some sort of compensating measures – for instance by adjusting public goods provision to the needs and interests of the richer, instead of the poorer, parts of society. The more complex and the less transparent a tax system, the easier it is for powerful groups to engage successfully in all kinds of rent-seeking and political lobbying.

Hence, an extension of the "Laffer curve" argument would place tax ceilings at a level where every additional dollar collected through a higher degree of progression were to be eaten up by lower tax revenues because of lower growth or tax evasion, *or* by higher compensatory expenses because of political pressure and rent-seeking. In cases of high inequality and low state autonomy, this point will be reached much earlier than in a setting characterized by high levels of cohesion and a strong state. Looking at existing tax regimes from such a political economy perspective makes it easier to understand why there

12 This observation applies to EU countries as well: Perry et al. (2006, 93) show *"that the Gini coefficient of taxes is very similar to the Gini coefficient of market incomes across the different European countries"*, although nominal progression is in place. Improvements of the disposable income distribution (income after taxes and transfers) compared to market income distribution in the EU 15 countries are considerable, but they are almost exclusively achieved through transfers. The Gini coefficient measures the distribution of assets within a given group. It assumes values between 0 (perfectly equal, every member of the group gets the same share) and 1 (perfectly unequal, one member gets all).

13 See IDB (2005, 187) for this point.

has been so little success in making progressive tax legislation work in developing countries.[14]

Yet another aspect of the complex relationship between distribution and taxation refers to *cycles* of growth and public finance. The distributive function of the state is countercyclical in nature: social spending is especially necessary in times of economic stagnation or recession. At the same time, if public revenue is based on taxing consumption through value-added taxes, it will have a pronounced procyclical behaviour. This means, in times of economic distress, authorities will be forced to look for other financial sources or alternatively cut spending, thus deepening the economic downturn. This has been a normal procedure in most Latin American countries in the past. In contrast, tax regimes based on direct taxes tend to behave less procyclically because the effects of economic recession are less immediate on total income and property than on consumption.

Legitimacy

Nobody actually *likes* to pay taxes, not even in the most democratic and equitable setting. Hence, higher levels of taxation will always carry a political price. As a matter of fact, hardly any successful electoral campaign has been based on the promise to raise taxes in order to finance more public goods. In contrast, cases abound where candidates have won elections pledging to cut taxes and pounding away at public spending. How come the most cohesive societies with the most democratic regimes have at the same time the highest tax quotas and the most progressive tax regimes?

A first approach would point to the gradual coming into being of the social market economy in western societies, and the concomitant rise of a pluralist system of interest articulation.[15] Following this argument, societies have gotten accustomed to big states with a large portfolio of public goods and services. Also, the public sector himself has grown into a powerful collective actor, resisting any attempt to reduce it in size or scope. But then again, taxes have never ceased to be a key political issue in any of the concerned countries. All over the EU, for instance, there are political parties that run on the ticket of radically lowering the tax burden and shrinking the state, mostly without getting a mandate to realize their project. Apparently, people in these countries do have a choice, they *want* a big state, and they willingly pay for it (if they must).

A second line of reasoning is based on public choice theory.[16] According to this approach, in representative democracies authorities engage in public good provision out of self-interest. The more encompassing the interest a ruler represents, the less he will redistribute to himself and the more he will spend on the provision of public goods. If a majority rules,

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14 Because of the described problems with progressive tax regimes, there has been a resurgence of the "flat tax" approach in recent years. A flat tax imposes one single tax rate on all taxable income. It is presumably easier to manage (both, for tax administrators and taxpayers) and may turn out to be more equitable than a tax regime that is progressive on paper, but regressive in practice. See Mitchell (2007); Cetrángolo / Gómez Sabaini (2007b, 63–72) for a detailed discussion.

15 This is the underlying argument of the original debate on governance issues *("ungovernability")* in western industrialized countries, pushed forward in the seventies as a conservative critique of the social-democratic welfare state. At that moment, problems of legitimation were widely discussed. See Offe (1984, 65–87); Crozier / Huntington / Watanuki (1975).

16 For the following argument, see Olson (2000).

it may give up self-privilegization altogether and treat the minority on equal terms, because by public good provision alone the point would be reached where the additional tax dollar spent by the state would be offset by the dollar lost through lower levels of production. However, while this argument connects taxation to public good provision, it does not explain *progressive* tax regimes. Why would income-maximizing, self-interested rulers inflict higher tax rates on themselves?

At this point, a third argument comes into play, referring to *legitimacy*. Legitimacy is an important aspect of social cohesion, although there is no linear relationship between both.[17] Societies with a minimum amount of cohesion create an institutional and normative setting in which the production and implementation of binding regulative and allocative decisions takes place. This setting can be called the *political order*. The representatives of any political order designed to last in time claim that this order serves a common good, beyond the interests of particular groups. The actual legitimacy of a political order rests on the acknowledgment of this claim by individual citizens and collective actors.[18]

In highly cohesive societies, legitimacy is typically based on a combination of procedural patterns (above all, representation and legality) together with material policies (the provision of public goods) and the realization of values shared by a majority of citizens (among these, distributional justice). In such a case, wealth carries a social obligation, and equity is considered a good in itself, not only a function of economic and social development.[19] Since states are endowed with the task of promoting justice and equity, their need to levy taxes is commonly accepted.

The fiscal dimension of legitimacy is sometimes illustrated by referring to a *fiscal covenant*. According to ECLAC (2007b, 13), decisive factors of such a covenant or contract include *"the size and composition of the tax burden, the countercyclical rule for social spending and its flexibility, the sectoral and subsectoral orientation of spending according to its progressive or regressive impact on equity, and clear and enforceable rules for explicit contingent liabilities when different public and private agents are involved in providing benefits."*

The fiscal covenant is fundamentally based on taxation. With other sources of revenue, such as rents or foreign aid, governments are financially independent from taxpayers, and the latter do not have strong incentives to monitor public spending, since it is not their money that is being spent. As a result, the contractual basis of mutual obligation and control does not work well in this case. As Moore (2007, 14–15) puts it:

> *"[...] if state elites need to depend on general taxation because they lack alternative, easier revenue sources, they generally have to put considerable organisational and political effort into obtaining the revenue, and face strong incentives to bargain and negotiate, directly or indirectly, with at least some taxpayers, rather than simply to*

17 There are political regimes that enjoy high levels of legitimacy even though social cohesion is low. Also, highly cohesive societies may at times grant little legitimacy to the political order governing them. In this latter case, however, it is difficult to imagine such a political order surviving for an extended period of time.

18 See von Haldenwang (2006) for an in-depth discussion of legitimacy and legitimation patterns.

19 For a recent discussion of different contractual approaches to distributional justice (Rawls, Nozick, Buchanan), see Arentz (2007).

> *extract revenue forcibly. In other words, dependence on general taxation provides incentives for state elites and taxpayers to resolve their differences through bargaining."*

Summary

Taxation plays a crucial role in all of the three dimensions of social cohesion discussed above. Tax revenues are used to finance public goods and services necessary for economic growth and competitiveness. Tax regimes based on economic activities instead of access to markets provide incentives to authorities to engage in market-friendly policies. Furthermore, in many countries taxes generate revenue needed to guarantee universal access to basic goods and services, a fundamental element of social cohesion and the primary distributional function of the state. In addition, broad-based progressive tax regimes reflect the importance attached to social mobility and equity in highly cohesive societies, thus promoting equity and adding to the legitimacy of the respective political order.

So far, the object under consideration has been the nation-state. However, current debates on social cohesion as well as public finance have an important territorial dimension. At which level of society should social inclusion take place? How are taxing and spending competencies distributed among different levels of government? The following chapter turns to the territorial dimension of taxation by discussing the issue of fiscal decentralization.

3 Fiscal Decentralization

The political economy of fiscal decentralization is one of the most scrutinized aspects of decentralization and multi-level government. The first contributions to the current debate date back to the 1950's, with Tiebout's seminal work on local fiscal choice and Musgrave's studies on public finance. About ten to fifteen years later, Buchanan wrote "Public Finance in Democratic Process", Olson coined the term *fiscal equivalence* in order to refer to the relationship of taxes and public goods provision, and Oates published his fundamental book on fiscal federalism.[20] In addition to these contributions, which drew much of their empirical groundwork from the US federal system, the Latin American debate on fiscal decentralization and tax reform has received important inputs from the research undertaken by Bird over the last four decades.[21]

What do political economy approaches tell about the role a decentralized tax system can play to promote social cohesion? Above all, there is no clear-cut case *in favour* of decentralization that could be deduced from the debate. The main challenge, as it seems, consists in finding a balance between the advantages of decentralized public finance systems in terms of responsiveness and service provision, and the disadvantages of decentralization with respect to economies of scale and equality.

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20 See Tiebout (1956); Musgrave (1959); Buchanan (1987); Olson (1969); Oates (1972). This is not the place to retell the story of fiscal decentralization. Excellent summaries of the debate can be found in Oates (2005, 350–56), Weingast (2006, 4–33), Weichenrieder (2000, 6–46), and Eckardt (1998, 8–69).

21 For instance, see Bird / Oldman (1968); Bird (1992); Bird (2000).

The decentralization theorem, economies of scope and fiscal equivalence

The conceptual foundations of a decentralized provision of public goods have been laid out by Oates's *decentralization theorem*.[22] This theorem states that under the conditions of regionally different preference orders and the absence of economies of scale in public good provision, a decentralized pareto-optimum provision of a public good will always be more efficient than, or at least as efficient as, a centralized provision. Decentralized systems provide public goods more efficiently, because they are able to reflect collective preference orders at a minor scale than centralized systems, thus reducing over- or under-consumption.

The argument has a political dimension, too: Electoral processes based on majority rules will always leave a minority frustrated. Now, if two policy alternatives, A and B, are put to vote, with option A being chosen by a majority, the number of frustrated voters in a decentralized system will be lower or equal, but never higher than in a centralized system, since there is a possibility that in at least one decentralized constituency voters prefer B over A.[23]

A first point in favour of fiscal decentralization, hence, lies in the fact that decentralized systems generate *economies of scope*, since they are better suited to respond to specific, geographically diverse preferences of citizens or local collectivities. Also, the transaction costs linked to information, contract monitoring and accountability may be lower in decentralized systems because of the proximity of citizens (as "principals") and public authorities (as "agents"). Finally, it is likely that voter satisfaction will be higher in a decentralized system, since the number of frustrated voters will be lower or, at most, equal compared to a centralized system. If social cohesion has something to do with the identification and satisfaction of collective preference orders, a decentralized system may thus be superior to a centralized system because of its sharper focus and higher responsiveness.

A related argument in favour of fiscal decentralization would refer to the principle of *fiscal equivalence* or *fiscal correspondence*.[24] The term denotes a situation, where there is *"a match between those who receive the benefits of a collective good and those who pay for it"* (Olson 1969, 482). In a world of perfect fiscal equivalence there is a complete congruence of economic, political and fiscal spaces. As a matter of fact, this principle bears close resemblance with the older and more general principle of *subsidiarity*. Subsidiarity means in this context that the production and provision of goods and services should take place at the lowest collective level that allows for the complete internalization of costs and benefits.

In theory, fiscal equivalence would have beneficial effects on social cohesion, since an important source of social conflict – the externalization of costs and internalization of benefits from collective action – would be under control. Also, fiscal equivalence would help to avoid situations of moral hazard linked to public finance in decentralized regimes: If local governments depend to a high degree on grants and transfers, they will usually prefer looking for additional funds from central government instead of increasing their

22 See Oates (1972, 35) for the original formulation, Oates (2006, 3–12) for a recent discussion.

23 See Weichenrieder (2000, 15) for that argument.

24 See Olson (1969), resp. Oates (1972, 33–35).

own tax revenues or cutting expenditure, because the latter two options are likely to cause resistance from local constituencies. If budget systems are weak and open to political pressure, local governments may even deliberately engage in deficit-spending, given the fact that they can rely on central government to bail them out. In contrast, under the rule of fiscal equivalence subnational entities would only receive transfer payments as a compensation for positive externalities generated by them.

Economies of scale and equality

The two principles – economies of scope and fiscal equivalence – taken together provide strong reasons for the promotion of fiscal decentralization, even under the perspective of social cohesion at a nation-state scale. They have the strongest impact, however, at the local level, reflecting an understanding of political order that tends to regard the local community as the fundamental political unit. At the same time, fiscal federalism theory also teaches us to be cautious with decentralizing fiscal competencies, out of the following reasons:

First, although useful as a general guideline for decentralization efforts, the principle of fiscal equivalence may turn out to be difficult to apply in real life. Important limitations arise, on the one hand, from issues of sovereignty and jurisdiction, since it is often impossible to prevent cross-border externalities. The number of cases where jurisdictional boundaries actually *follow* public goods boundaries is presumably rather small. In the more frequent case where jurisdictional and public good boundaries do not match perfectly, the fiscal decentralization literature mentions interjurisdictional cooperation as an option – for instance *via* joint service agencies (either single or multi-purpose) covering various municipalities within a metropolitan area.[25]

On the other hand, there may be problems of efficiency (tax systems may turn out to be overly complex if fiscal equivalence is pushed to its limits) or capacity (it may be too difficult or expensive to obtain the necessary data to determine the exact distribution of costs and benefits) operating against fiscal equivalence. Finally, there is the dimension of time: Some public policies – just think of education or environmental protection – lead to a new distribution of costs and benefits between generations, something fiscal equivalence does hardly account for.[26]

Second, in addition to these practical problems, a counterweight to the principle of fiscal equivalence and the beneficial effects of economies of scope is provided by the generation of *economies of scale* through larger-scale tax collection. Often, it is easier and less expensive to levy taxes at the intermediate or national instead of the local level – even if from a fiscal equivalence perspective a local solution would be preferable. This is especially true in cases where local agencies are underfunded, badly managed, technically obsolete and vulnerable to political pressure (Djafari 2007, 67–68). Collecting different taxes through one and the same agency may provide additional benefits in terms of efficiency and effectiveness.

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25 Eusepi (2000, 309) has coined the term „contractual fiscal equivalence“ to account for the internalization of spillover effects through contractual relations between individuals or jurisdictions.

26 The literature suggests, however, that investments in long-lived assets should be financed by raising debt, so as to ensure equitable burden-sharing across generations (Shah / Shah 2006, 11).

In this sense, excessive decentralization can make a tax system costly and inefficient, undermining the state's capacities to pursue public policies geared towards social cohesion. Also, levying taxes at a higher level of government may be advisable in order to capture positive externalities generated by local public good provision. These resources could then be channelled back to the local level through grants or subsidies (Olson 1969, 485–86).

Third, as a downside to the above-cited argument of higher responsiveness through decentralization, focusing on local preference orders alone may put in danger the minimum uniformity of public goods provision necessary for a sustainable degree of social cohesion in modern nation-states. Such a situation is especially dangerous in societies with weak internal cohesion, important ethnic or territorial cleavages, or highly segmented economies.

Considering the revenue system, local fiscal choice theory maintains that within certain limits differences in local taxation are useful to trigger healthy competition between territorial units. The expected outcome would be a more efficient provision of public goods and / or a lower tax burden.[27] However, if tax revenue levels differ too much, they may contribute to all kinds of unwanted outcomes, ranging from an undersupply of public goods and services to large-scale internal migration and brain drain in poorer regions, diseconomies of urbanization, overuse of natural resources or even moral hazard, if local governments try to shift the burden of revenue-raising to the central level.

Also, under conditions of open market economies and competition for new investments, high degrees of decentralization may result in a fiscal race to the bottom, where subnational governments try to obtain foreign investments through overly generous tax cuts, subsidies, the lowering of environmental or labour standards and so on. Such a preferential treatment will not only affect the immediate public utility of private investments and cause market distortions, but it may also damage the cohesion of (local) society in more than one way, for instance by diminishing public resources available for social policies, by promoting informal or sub-standard employments, by bringing additional environmental problems on the community, by creating or fostering a dualistic enterprise structure, etc.

Fiscal decentralization in less-than-perfect settings

Economies of scope can only be reaped if changes in the preference order of the citizens effectively lead to changes in the mix of public goods provided by local authorities. Fiscal federalism is therefore based on two assumptions: On the one hand, authorities are considered to be true *representatives* of the interests of their constituency (Weichenrieder 2000, 32).[28] On the other hand, democratically elected authorities are entitled to decide through legal procedures which policies serve best the *common interest* of a community. This is important because even within the most decentralized system individual preferences have

27 This view has been supported by recent empirical findings discussed by Oates (2005, 355–56): *"(W)here decentralization involves reliance on own taxation at provincial and local levels, it is indeed associated with smaller government. But where decentralized government is financed primarily with transfers from above, the opportunities for 'raiding the fiscal commons' can result in perverse programs that actually increase the size of the overall public budget."*

28 Olson's model of power and public good provision is based on the same assumption (Olson 2000, 2–20).

to be aggregated collectively, and public goods provision almost always implies having to compromise on where to spend scarce resources.

Unfortunately, existing political orders are not always characterized by true representation and effective common interest orientation. What if authorities routinely pursue their narrow self-interest instead of representing their constituency? What if citizens cannot trust in that the aggregation of individual preferences is being done in a transparent, legal and democratic way? What do political economy approaches to fiscal decentralization have to say about less-than-perfect political settings?

A first answer is provided by "second generation fiscal federalism" (SGFF). This school of thought differs from first generation fiscal federalism (FGFF) in that it drops the assumption of public decision-makers as benevolent maximizers of social welfare. Instead, the incentive structure governing the behaviour of decision-makers is taken into account as a factor that shapes fiscal regimes and public policies. [29]

SGFF would point out that under the condition of fiscal decentralization, *competition* between political units serves as a limiting factor to self-privilegization, just as it curbs monopolistic rent-seeking behaviour among economic actors. In order for decentralized regimes to work that way, a "market-preserving" institutional framework has to be in place:[30]

1. Subnational governments must enjoy autonomy, i. e., they must have the authority to adapt policies to their circumstances.
2. There must be a common market that allows factor and product mobility.
3. Governments at all levels must be exposed to hard budget constraints. This means, they have to bear the financial consequences of their policy decisions.
4. The distribution of competences among government levels must be institutionalized, in order to limit discretionary or unilateral control on behalf of central government.

It is easy to see that each and every one of these conditions shapes the incentive structure of local authorities. In a situation where all four conditions are met, competition will indeed be likely to play an important role in government decisions, even if the perfect representation or benevolent ruler assumption of first generation fiscal federalism is given up. At the same time, conditions 1 and 4 provide an effective protection against predatory behaviour on behalf of central government, since extensive centralization of fiscal powers is often used as political leverage to coerce local governments into obedience. As Weingast (2006, 9) puts it: *"Market-preserving federalism limits the exercise of corruption, predation, and rent-seeking by all levels of government."*

However, looking at real life societies and political regimes, the market-preserving conditions are not as clear-cut as they appear at first glance. For instance, the first and the fourth condition are quite difficult to operationalize. What degree of autonomy and what kind of authority are necessary so that local authorities can adapt policies to changing circumstances? Where does rightful promotion of national unity or development end, and discre-

29 See Oates (2005) and Weingast (2006) for a detailed discussion.

30 The term "market-preserving federalism" has been introduced by Weingast. For the following enumeration of market-preserving conditions see Weingast (2006, 4–10).

tionary or even authoritarian intervention by central governments begin? Public policies are often executed in steps or sequences, involving a large number of institutional actors. It is not always easy to determine which part has to be decentralized and which part should remain under central government control. In a world of growing interdependence and multilevel governance, a model that rests on the perfect delimitation of authority spheres may lead us astray instead of helping us to improve our understanding of decentralization.

Concerning tax systems in particular, there are some additional problems with autonomy and authority. Most importantly, many taxes are neither purely centralized nor purely local. Following Bird (2000, 16), *"a completely subnational tax might be defined as one that is assessed by subnational governments, at rates decided by subnational governments, which is also collected by subnational governments, with its proceeds accruing to subnational governments. In the real world, however, many taxes may possess only one or two of these characteristics, and the 'ownership' of the levy may be unclear."*

With respect to the second condition, factor mobility may be diminished by ethnic, cultural or linguistic cleavages, by kinds of economic activity (e. g. agriculture, mining) or by a lack of information. Typically, the poorest sectors of society are less mobile than the average citizen, while at the same time they are more affected by bad governance. Also, even decentralized democratic regimes often possess characteristics that do not entail strong incentives for mobility. If, for example, electoral systems rule out re-election, or if political collectivities are weak and personalism is a main feature of political culture, political cycles may turn out to be so short and effective competition so weak that they do not bring about the necessary incentives for better governance. In such a case, migration to another community is not an attractive option – at least as a reaction to self-privilegization and bad rule.

Regarding the issue of taxation and social cohesion, the third condition is especially relevant. The hard budget constraint can be read as a reformulation of the fiscal equivalence principle: Central government should be protected from moral hazard behaviour by subnational units, while subnational authorities should not be exposed to central government leverage and predatory behaviour. This is especially important because politicians at all levels of government will always prefer to maximize revenue from external sources over raising funds from their own constituency or having to cut down spending.[31]

From a political economy standpoint, there are only three types of situations where central government transfers to local government make sense. *First*, to compensate efficiency losses stemming from spillovers of local public good provision. *Second,* to redistribute revenues which were collected centrally in order to generate economies of scale. *Third*, to enable subnational governments to provide minimum levels of public goods (Weingast 2006, 13–23).

It is especially the third type of transfers that has to be treated carefully, so as not to invite local governments to regard it as a soft budget constraint. The political economy literature on fiscal decentralization has a clear tendency to favour the beneficial effects of a hard

31 See Oates (2005, 360–64) for a more detailed discussion. Webb (2004, 3) discusses the problem of free riders in a situation where national and subnational governments agree on maintaining fiscal discipline.

budget constraint over the idea of maintaining national unity or promoting regional competitiveness through active redistribution schemes. From a social cohesion or a political legitimacy perspective, however, excessive economic and social heterogeneity or the need to get a majority in parliament to pass legislation may at times be more pressing problems than the risks embodied in fiscal transfers to subnational governments.

Summary

Political economy approaches to fiscal decentralization provide important criteria for the analysis of public finance regimes and their role for social cohesion. They should not be understood, however, as iron rules that apply equally in every possible setting – mainly, because the political models they employ do not always reflect real life complexity.

Above all, the literature suggests that anybody concerned with taxes should be suspicious of situations where the costs of public goods provision and the benefits arising from their consumption do not fall upon the same group of actors. According to theoretical reasoning, this constellation breeds all kinds of problems, from deficient public goods provision to moral hazard and interjurisdictional spillovers.

As a result, conventional approaches to fiscal decentralization sometimes recommend a rather limited role for local governments:

> *"The only good local taxes are said to be those that are easy to administer locally, that are imposed solely (or mainly) on local residents, and that do not raise problems of 'harmonization' or 'competition' between subnational governments or between subnational and national governments."* (Bird 2000, 16)

These criteria apply, above all, to residential property taxes and user fees.

At the same time, however, in heterogeneous settings most local governments will hardly be able to provide basic goods and services to the local community relying on property taxes and user fees alone. The assignment of additional taxes (for instance, on vehicles or on the consumption of specific goods) to the local or intermediate level should be guided, apart from the principles discussed above, by the ability to monitor relevant assessments and the matching of revenues with expenditure needs (Shah / Shah 2006, 11).

Even broadening the approach by including additional taxes, there will always be a need for transfer payments to compensate for differences between groups or territorial units. Policy-makers and citizens should be alert about the risks this constellation entails, and about the potential benefits of fiscal reforms geared towards a higher degree of fiscal equivalence, but they should also be cautious about models that do not account for relevant social values such as solidarity and equity.

Another important message from the debate on fiscal decentralization would be that local dependency on central government transfers might stimulate rent-seeking and moral hazard on both sides. Holding governments fiscally responsible for their own political decisions means that additional revenues raised at the local level should not be swallowed by central governments or disappear in common revenue pools. The literature suggests that strengthening local revenue raising capacities will have positive effects not only in fiscal terms, but also in terms of accountability and responsiveness. It will thus help to promote both, economic growth and social cohesion – at least at a local level.

4 Latin America

As has been argued in the preceding chapters, social cohesion is not only a function of objective levels of welfare and public good provision, but also of an equitable distribution of social resources. Further, the promotion of social cohesion is positively associated with broad-based legitimacy. All three dimensions of social cohesion are affected by high income polarization. Latin America is the world region with the highest income disparities. With a Gini coefficient of 0.51, it is much more unequal than, say, Asia (0.41) or the OECD (0.33) (ECLAC 2007b, 62). Even worse, Latin America has a long history of inequality, which means that inequality has deeply penetrated the societies, there institutions, habits and values.

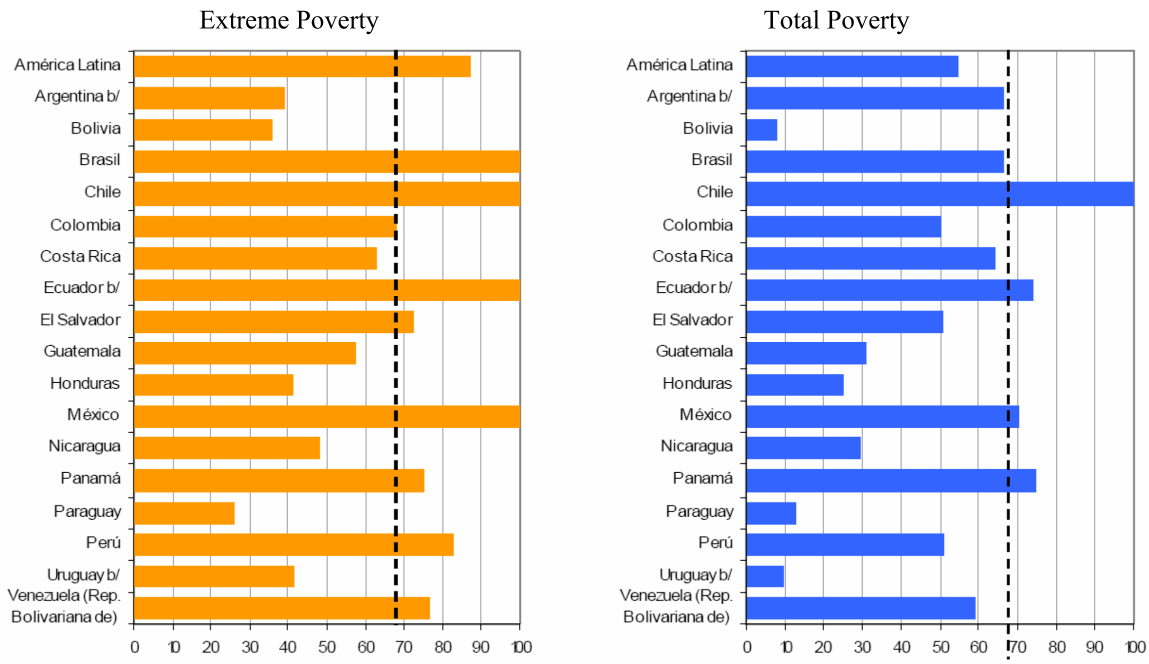
Higher income polarization translates, among other things, into a lower poverty incidence of economic growth, although apparently recent developments are pointing in the opposite direction: In 2007, Latin America registered its fifth year of economic expansion in a row, with an average annual per capita growth of almost 3.5 %. Growth combined with an increase in social spending has led to important progress with respect to the first Millennium Development Goal (MDG)[32] (see Figure 1, left column).

In contrast, the unequal distribution of income and wealth has remained largely unchanged in most countries, with only few exceptions. As a result, progress in the reduction of *total* poverty (Figure 1, right column) has been much more difficult to achieve. This is not a necessary or inevitable tendency: According to ECLAC, improving the Gini coefficient by only a little more than 5 % would lead to a development path where the historical real per capita growth rate of the region (around 2 % per year) would suffice to cut overall poverty by half until 2015 ECLAC (2007a, 19). There is little evidence, however, that these improvements can be brought about without an active role of the state and without further tax reforms.

The issues of justice, equity and participation are dominating the political agenda in Latin America today, even in a situation where many macro-indicators of social development are performing relatively well. It appears that in the eyes of large parts of civil society, there is an agenda for public action which has not been properly attended by the state in Latin America. The question is, however, whether the Latin American states are actually prepared to assume a more active role in promoting social cohesion.

32 In September 2000, the member states of the United Nations agreed upon a set of eight development goals to be achieved until 2015. The first of these goals sets out to cut extreme poverty by half (taking the year 1990 as a baseline). Extreme poverty was defined as living on less than one dollar a day (adjusted for purchasing power parity).

Figure 1: Latin America (17 countries): Progress in reducing poverty between 1990 and 2007[a]



a Figure 1 shows the progress made by Latin American countries as a percentage of total progress needed to cut poverty by half until 2015. The vertical dotted line indicates where countries should stay at the end of 2007, given a steady improvement between 1990 and 2015. In countries marked with "b/", data refer to urban areas alone.

Source: ECLAC (2007a, 17)

The following paragraphs show that despite recent reform efforts and growing public revenues there remain some important shortcomings concerning the tax system, tax administration capacity and fiscal decentralization in many Latin American countries.

Tax systems

Quite often, references to developing countries' tax efforts start out just as the present document did: by comparing them to the OECD.[33] This, however, is somewhat misleading, since historical as well as current comparative analyses clearly show a positive association of GDP per capita with the revenue share of the public sector. In other words: growing GDP per capita usually goes hand in hand with a growing capacity of the state to levy taxes (Perry et al. 2006, 92–97). This is true for developing as well as for industrialized countries: The current situation in the industrialized world is an outcome of developments over the last century.[34] Against this background it would hardly be fair to demand

33 See for instance Witt / Trinks (2007, 60) (reference to sub-Saharan Africa).

34 As Genschel (2005, 55) observes, *"in the major industrial countries, the tax take as a share of Gross Domestic Product (GDP) rose from an average of 10 % or less before the First World War to around 30 % fifty years later, and almost 40 % at century's end."*

from Latin American countries to raise tax collection up to OECD levels in the near future.

To be sure, over the last decades Latin American governments have introduced important changes to pre-existing tax regimes. Cetrángolo / Gómez Sabaini (2007a, 26–29) observe the following trends:[35]

- A significant increase, both in nominal rates and in extension, of general taxes on goods and services (VAT);
- a simplification of tax regimes through the abolition of minor taxes and the reduction of the number of taxes (although accompanied by the rise of "heterodox" taxes on financial operations, credits, etc.);
- a falling participation of taxes on international trade and transactions in the wake of market opening, regional integration and foreign trade liberalization;
- a rather gradual increase in the importance of income and property taxes, accompanied by a steep decline of nominal tax rates;
- a falling share of social security contributions based on salary deductions, as a result of the growing importance of private security schemes;
- the introduction of simplified regimes for small taxpayers;
- the almost complete eradication of the – highly inequitable – "inflation tax".

But even accounting for GDP per capita levels and recent reform efforts, Latin American tax collection is lagging behind in comparative terms. This point is highlighted by ECLAC (2007b, 134): *"the overall tax burden in most of the countries is about a third lower on average than it should be given their per capita income levels. In absolute terms, their tax burdens should be three to four points of GDP higher."* And Perry et al. (2006, 96) observe: *"In effect, the only tax that Latin America seems to be collecting more or less in accordance with the international experience is the goods and services tax." So, most Latin American countries could, and should, do more to increase tax collection.*

Not only is the tax burden of most Latin American countries low in comparative international standards (with Brazil, Uruguay and Argentina being the exception), but also is the effect of taxation on income distribution presumably regressive rather than progressive. This is the "result of tax systems that rely heavily on indirect taxes and of benefits and exemptions that go mainly to higher-income sectors" (ECLAC 2007b, 133–134).[36] Collection of progressive taxes (income and property taxes), in turn, has been especially low in this region (see Table 1).

35 See also Sanchez (2006); Lora / Cárdenas (2006, 9–13); Gómez Sabaini / Martner (2007, 8–16).

36 For a more detailed discussion of the existing literature on the distributive effects of taxation in Latin America, see Cetrángolo / Gómez Sabaini (2007a, 29–44). Although most findings support the thesis that regional tax regimes are rather regressive, the authors recommend to be cautious with general statements, since the data material is not always trustworthy and important factors, such as the incidence of inflation and alternative sources of public revenue, are usually left out. Following Lora / Cárdenas (2006, 4), the distribution of tax pressure has notably improved in the first half of the 90s, due to the above-mentioned changes in tax rates and a significantly higher productivity of tax collection.

Table 1: Latin America and OECD: Composition of Tax Revenue, 2005 (% of GDP, simple average)

	TOTAL	Income and capital gains	Property	Goods & services and int'al. trans-actions	Other taxes	Social Security
Latin America *(% of total tax revenue)*	17.1 *(100)*	3.9 *(22.8)*	0.8 *(4.7)*	9.8 *(57.3)*	0.0 *(0.0)*	2.6 *(15.2)*
OECD *(% of total tax revenue)*	36.4 *(100)*	12.9 *(35.4)*	2.0 *(5.5)*	11.5 *(31.6)*	0.7 *(1.9)*	9.3 *(2.6)*
EU 15	40.1	13.7	2.1	12.1	0.9	11.3
USA	26.8	12.5	3.0	4.6	0.1	6.6
Japan	26.4	8.5	2.6	5.3	0.0	10.0

Source: Own calculations using data from Cetrángolo / Gómez Sabaini (2007a, 22–23)

Following the advice of supply-side economics, most Latin American countries have lowered nominal income tax rates in the second half of the 1980s and the 1990s. Between 1986 and 2004, average nominal ceiling rates have been reduced from 49.5 % to 28.9 % for personal incomes, and from 43.9 % to 26.6 % for corporate incomes. At the same time, entry levels for taxable incomes have been increased, while the income thresholds where maximum tax rates apply have been lowered. Corporate income tax spreads have disappeared almost completely, as most tax regimes have been converted to corporate flat tax schemes (Gómez Sabaini 2006, 82–85; Lora / Cárdenas 2006, 10).

As Table 2 shows, the participation of direct taxes in overall tax revenue (including social security) has grown steadily, from 22.5 % in 1990 to 28.1 % in 2006. This is a notable progress, but it appears to be largely due to higher corporate tax payments, especially from the resource-extracting industries. At any rate, participation remains still more than 12 percentage points below OECD levels (see Table 1), even though nominal rates have converged considerably.

A closer look at the tax structure reveals yet another two important limitations. First, in the Latin American region direct taxes are levied to a much larger extent on enterprises than on personal incomes, quite contrary to the OECD: Taxes from private income in Latin America amount to a mere 39.0 % of total revenue from income and capital gains taxes, whereas 72.6 % of total OECD revenue from this source were collected from private households (Cetrángolo / Gómez Sabaini 2007b, 12).[37] Second, the whole tax structure is highly exposed to the economic cycle because of its dependence on consumption instead of income and property. The VAT is by far the most important tax all over Latin America, accounting for almost one third of tax revenue (Sánchez 2006, 790–91).

37 The numbers cited above are based on data from nine Latin American countries (Bolivia, Brazil, Chile, Colombia, El Salvador, Honduras, Mexico, Panama and Peru), covering different years between 1999 and 2005. OECD data are from 2003. Of the nine Latin American countries, only Brazil collects a significantly larger share of income taxes from enterprises (4.3 % of GDP) than from private households (2.6 %, 2005 data).

Table 2: Latin America: Central Government* Tax Revenue, 1990–2006 (% of GDP, simple average of 19 countries)**						
	1990	**1995**	**2000**	**2004**	**2005**	**2006**
Revenue from direct taxes *(% of total tax revenue incl. social security contr.)*	2.7 *(22.5)*	3.4 *(23.8)*	3.7 *(24.3)*	4.3 *(26.4)*	4.7 *(27.5)*	5.0 *(28.1)*
Revenue from indirect taxes *(% of total tax revenue incl. social security contr.)*	7.2 *(60.0)*	8.4 *(58.7)*	8.9 *(58.6)*	9.4 *(57.7)*	9.8 *(57.3)*	10.1 *(56.7)*
Total tax revenue	9.9	11.8	12.6	13.7	14.5	15.1
Social security contributions	2.0	2.5	2.6	2.6	2.6	2.7
Total tax revenue (incl. social security contributions)	**12.0**	**14.3**	**15.2**	**16.3**	**17.1**	**17.8**

* Data from Argentina and Brazil cover general government because of the importance of subnational tax collection in both countries.

** Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela.

Source: Own calculations using data provided by the ECLAC-ILPES Data Base on Public Finance

As a result of the described characteristics, most Latin American tax regimes have a threefold negative impact on social cohesion:

— They do not generate sufficient resources in order to meet the requirements of social spending and public investment, thus affecting both the primary distributive function and public good provision for economic growth;

— they do not provide a stable revenue basis over a sustained period of time, making it difficult to plan and manage public budgets in a countercyclical way, and to inspire trust in public sector behaviour;

— they do not contribute to strengthening the dimension of equity within Latin American societies, but rather exacerbate the already existing polarization of income.

Hence, it comes as no surprise that in the past fiscal management did not enjoy high rates of public approval and trust in Latin America, thus adding to the precarious nature of legitimacy in many countries of the region. Citing a Latinobarómetro poll of 2003, the IDB notices that "75 % of Latin Americans believe taxes are not used efficiently" (IDB 2007, 1).

Recent macro-economic and fiscal trends, however, are positive.[38] Thanks to a period of sustained growth initiated in the second half of 2003, most Latin American countries are currently witnessing a solid increase in public revenue (see Table 2). In combination with a surprisingly responsible spending behaviour,[39] this has led to a notable improvement of their main fiscal figures. For the first time in decades, the region registered a total budget

38 The following remarks are based on ECLAC (2007c, 9–47).

39 This achievement is especially remarkable since it has been accompanied by a sustained increase of social spending since 1990 (ECLAC 2007b, 138). Also, the recent years have seen a resurgence of the left in Latin America, mostly running on the ticket of overcoming the traditional equity gap and promoting social justice, but without (so far) sacrificing fiscal discipline (Lora / Cárdenas 2006, 3–4).

surplus (after debt service) of 0.2 % of GDP in 2006. Public debt has been significantly reduced.[40] Those countries that experienced soaring export prices are at the same time those with the highest increase of fiscal revenue – underlining the above-mentioned pro-cyclical character of public revenue in the region. However, in general terms Latin America presents better fiscal figures and a higher degree of credibility today than at any point in the last three decades.

Tax administration capacity

The current state of tax revenue in Latin America is not only an outcome of changes in tax structure and economic growth, but also one of the effectiveness of tax administration. As the IDB (2005, 186) observes:

> *"In the face of the challenges of globalization, taxation policy has been a very active area of reform. Every Latin American country has undertaken important reforms in this area since 1990 (...) and 11 Latin American countries have overhauled their tax systems since that time."*

Baer (2006, 132–146) summarizes the main tendencies of tax reform as follows:

- Governments have placed considerable emphasis in the modernization of their tax administrations. This objective has been pursued by increasing the professional capacities of employees, by integrating different administrations (internal tax agencies, social security, customs) in one single body, and by establishing different regimes for large, intermediate and small taxpayers. In general terms, modernization efforts have addressed both pillars of tax administration: the promotion of voluntary compliance through service improvements, predictability, transparency and user orientation, as well as the control and sanction of incompliance.
- With respect to procedures, the role of the banking system in tax collection has been strengthened almost everywhere. Also, modern information and communication technologies (ICT) are now widely used for keeping tax registries, processing declarations and payments, control of tax yields, auditing, reporting and collection. In principle, ICT has also enhanced tax administration's capacities to exchange data and cross-check information. In practice, however, technical, procedural and legal obstacles have hampered this kind of cooperation.
- Tax administrations operate in an institutional setting that is still characterized by high normative complexity and a lack of transparency, even taking into account governments' initiatives towards tax simplification. Also, tax administrations often lack the legal competencies or the capacities to audit, detect and effectively sanction tax evasion. Slow and inefficient judicial systems contribute to this picture. In some cases, frequent changes in tax legislation and the widespread use of amnesties have added to the low credibility and hence, capacity of tax administration.

Fiscal decentralization

Up-to-date information on the participation of Latin American subnational governments in total tax revenue is hard to come by. ECLAC-ILPES provides data on central government

40 At the end of 2006, the non-financial public sector debt stood at 39.5 % of GDP, down from 63.4 % in 2002 and 43.9 % in 2005. See ECLAC (2007c), Statistical Annex, A-43.

versus general government tax revenue in eight countries (see Table 3). From this and additional information about total subnational revenue (see Table 4) it can be deduced that there are three broad categories of countries in the region.

Table 3: Latin America: Subnational Governments Share of Tax Revenue, 1990–2006 (% of GDP)

	1990	1995	2000	2004	2005	2006
Argentina *(% of total tax revenue excl. social security contr.)*	4.1 *(33.9)*	7.3 *(47.1)*	8.4 *(46.4)*	9.7 *(41.6)*	9.8 *(41.5)*	9.8 *(41.5)*
Bolivia *(% of total tax revenue excl. social security contr.)*	0.2 *(2.8)*	1.5 *(12.4)*	1.1 *(8.2)*	…	…	…
Brazil *(% of total tax revenue excl. social security contr.)*	8.5 *(46.4)*	8.5 *(46.7)*	8.9 *(47.6)*	9.1 *(48.7)*	9.3 *(47.9)*	9.6 *(48.0)*
Chile *(% of total tax revenue excl. social security contr.)*	1.1 *(7.4)*	1.2 *(7.2)*	1.5 *(8.4)*	1.4 *(8.2)*	1.4 *(7.7)*	1.3 *(7.1)*
Colombia *(% of total tax revenue excl. social security contr.)*	2.2 *(22.0)*	2.5 *(20.5)*	2.7 *(19.4)*	3.0 *(18.0)*	3.2 *(17.8)*	…
Costa Rica *(% of total tax revenue excl. social security contr.)*	0.3 *(2.7)*	0.2 *(1.7)*	0.7 *(5.6)*	0.9 *(6.5)*	0.9 *(6.3)*	1.0 *(6.7)*
Ecuador *(% of total tax revenue excl. social security contr.)*	0.6 *(7.1)*	1.4 *(16.5)*	1.6 *(13.6)*	1.5 *(13.4)*	1.3 *(11.2)*	…
Uruguay *(% of total tax revenue excl. social security contr.)*	1.6 *(9.9)*	2.2 *(13.1)*	2.4 *(13.6)*	…	…	…

Source: Own calculations using data provided by the ECLAC-ILPES Data Base on Public Finance

- At the top, there are two countries with a federal political order, Argentina and Brazil. Here, subnational (provincial or state) governments wield substantial revenue-raising power. Their share of total tax revenue is above 40 %, in Brazil even approaching 50 %.
- Next, there is a group of countries where subnational participation is substantial, but without reaching the levels of Brazil or Argentina. This group would include Colombia, Bolivia and Mexico. Especially in the latter two cases, the lack of subnational tax collection is compensated by a sizeable participation in other revenue sources, above all royalties from the extraction of oil and gas. In Colombia, transfers from central government under the 1991 constitution rulings were geared to elevating the share of subnational governments up to almost 50 % of total public revenue, although this level has never been reached in practice.
- The third, and largest, group consists of those countries where subnational governments have limited taxing powers and do not receive a large share of total public revenue. Among these countries, Ecuador and Peru may eventually move to the second group as a result of fiscal decentralization, but available data does not support such a classification at this point in time.

It is important to keep in mind that subnational tax revenues are not always actually *levied* by subnational governments. In fact, it is quite common for national tax administrations to collect subnational taxes and than channel revenues back to the lower levels of govern-

Table 4: Latin America: Subnational governments fiscal indicators, 1998–2005 (% of GDP)									
		1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Argentina:	Total revenue	11.1	11.4	11.5	11.2	10.4	11.3	12.8	13.4
	Total spending	11.7	12.8	12.6	13.6	10.9	10.9	11.8	13.1
Bolivia:	Total revenue	7.2	6.8	6.3	7.8	8.1	7.7	8.5	10.5
	Total spending	7.3	7.0	6.4	7.9	7.9	9.6	8.0	8.3
Brazil:	Total revenue	13.9	12.8	12.9	12.9	12.8	12.3	...	...
	Total spending	14.6	13.1	12.8	13.1	13.1	12.4		
Chile:	Total revenue	3.0	3.3	3.2	3.2	3.3	3.1	2.7	2.9
	Total spending	3.0	3.2	3.3	3.2	3.3	3.1	2.7	2.7
Colombia:	Total revenue	7.2	7.8	7.6	7.8	8.6	9.0	9.1	9.2
	Total spending	7.7	8.3	8.2	7.8	8.5	8.7	8.3	9.0
Costa Rica:	Total revenue	0.7	0.6	0.8	0.9	0.9	0.8	0.8	0.8
	Total spending	0.7	0.8	0.7	0.8	0.8	0.8	0.8	0.8
Ecuador:	Total revenue	2.5	2.3	2.8	3.9	4.0	3.7	4.3	4.0
	Total spending	2.2	2.2	2.1	3.3	3.8	3.3	4.2	3.7
Mexico:	Total revenue	6.1	6.6	6.9	7.5	7.5	7.8	7.7	...
	Total spending	6.0	6.4	6.8	7.5	7.6	7.7	7.6	
Paraguay:	Total revenue	0.3	0.4	0.4	0.4	0.3	0.3	0.5	0.5
	Total spending	0.3	0.4	0.4	0.4	0.2	0.3	0.5	0.5
Peru:	Total revenue	2.1	1.9	2.1	2.1	2.1	2.2	2.3	2.5
	Total spending	2.1	2.1	2.1	2.1	2.1	2.1	2.2	2.2
Source: ECLAC (2007c, Statistical Annex, A-44)									

ment. Perhaps the most prominent example is Argentina, where the federal government collects and redistributes taxes under a “co-participation” scheme negotiated and agreed upon by both sides, central state and provinces. The problem with such a procedure, in Argentina and elsewhere, is that subnational governments tend to regard these revenues as transfers, thus losing the incentive to engage in market-friendly policies. This is especially the case in situations where the distribution of revenues follows other criteria apart from restitution – for instance the compensation of different public revenue levels – or where distributive discretion is high.

Typical taxes levied at the local level include property and industry and trade taxes.[41] They offer the advantage of taxing productive assets that cannot be moved easily. However, certain properties of these taxes, such as their high visibility and the need to maintain up-to-date registers tend to affect their productivity. As a result, they rarely account for more than 20 % of local tax revenue. Other taxes, such as the automobile tax or taxes on the consumption of specific goods have come to complement the local tax structure. In general terms, however, there is a considerable potential for local taxes not adequately used in many countries of the region.

41 For this paragraph, see Lora / Cárdenas (2006, 15–17).

The picture drawn in Table 3 reflects tax revenues alone. It changes when other revenue sources are taken into account, above all central government transfers and royalties from the extraction of non-renewable resources. As can be deduced from comparing the information provided by Tables 3 and 4, with the exception of Costa Rica, subnational governments were able to increase their revenues substantially beyond their tax share. In some cases (Bolivia, Colombia), differences amount to more than 5 % of GDP. In proportional terms, revenues from other sources added between 30 % and more than 400 % to subnational tax revenue.

With respect to transfers, it has been said above that the theoretical literature on fiscal decentralization allows only three types: compensation for externalities, co-participation of revenues collected at the central level in order to generate economies of scale, and subsidies for public goods provision for the sake of national minimum standards, in the face of considerable fiscal disparities. In any case, transfer systems should be market-preserving. Shah makes a strong point in favour of performance-based transfers which link grant finance to service delivery performance (Shah 2007, 9–51).

In Latin America, intergovernmental transfer systems have often failed to fulfil the requirements of market preservation or performance orientation laid out above. In part, this has been an outcome of factors not accounted for by fiscal decentralization models, such as the distortions generated by the extraction of non-renewable resources, the existence of political or social cleavages or the effects of spatially unbalanced development patterns and the ensuing heterogeneity of subnational units. All too often, however, the transfer systems themselves have been flawed:

On the one hand, the politicization of grants and transfer systems combined with a high degree of discretionalism has invited subnational governments to all kinds of rent-seeking and moral hazard behaviour. In some countries, such as Argentina, Brazil or Colombia, subnational governments have at times used deficit-spending to a degree that has put the whole system of public finance and macroeconomic adjustment in serious jeopardy, relying on central government transfers to bail them out. On the other hand, discretionary grants and subsidies have been used by central governments as a leverage to impose their political agenda, coerce subnational authorities into obedience, and create, maintain or strengthen clientelistic relations between voters and political elites.

In summary, the present shape of fiscal decentralization in Latin America does hardly fit the prescriptions outlined in the preceding chapter of this paper. Neither do subnational governments (with few exceptions) enjoy strong revenue-raising powers that would encourage them to strengthen responsiveness towards local preferences, nor do existing transfer systems follow the principles of market-preserving federalism. At the same time, there is little evidence that transfer systems are sufficiently strong and well focussed to mitigate the territorial heterogeneity that characterizes most countries of the region.

As a result, fiscal decentralization has gained a bad reputation in Latin America. It is widely regarded as a destabilizing factor in macroeconomic and fiscal management. Those countries that have deepened fiscal decentralization in recent years or decades (such as Colombia, Bolivia or Ecuador) are looked upon with concern. In contrast, countries with centralized fiscal authority and a strong predominance of the executive over parliament in the budget process are considered to be better equipped to face the challenges of sustainable, countercyclical fiscal policy. It is not by incidence that politicians and experts tend to regard Chile as the regional benchmark for responsible and development-oriented fiscal management – being Chile one of the countries with the highest degree of centralization in the region.

However, adherents to fiscal decentralization have learned from the errors of the past. Among the most important policy innovations, various countries (Argentina, Brazil, Colombia, Peru, Ecuador, Venezuela, Mexico to a certain degree) have passed *fiscal responsibility laws* in order to control the fiscal behaviour of national governments and subnational entities.[42] These laws and accompanying regulations usually aim at strengthening fiscal discipline, transparency and credibility by

- setting targets and limits to key fiscal indicators such as net debt or current expenditure in relation to revenues (debt ceilings, expenditure ceilings – for instance, on payroll expenditures or interest payments –, primary deficit targets, restrictions on borrowing);
- establishing ex-ante and ex-post monitoring and enforcement procedures, and imposing sanctions in the case of non-compliance, including criminal prosecution of fiscal authorities through fiscal crimes laws;
- introducing a common framework for fiscal projections, annual and pluriannual budget planning and reporting, including public access to information and disclosure of fiscal results;
- creating fiscal stabilization funds as a means for countercyclical fiscal management.[43]

Fiscal responsibility laws do not always explicitly include subnational governments. However, in setting standards and imposing targets and limits they affect subnational behaviour even in cases where local or intermediate governments are not covered in legal terms. The exact incidence of fiscal responsibility laws on the performance of Latin American governments is difficult to assess, given the relatively short period of time since their enactment in most cases. To be sure, a notable success has been achieved by Brazil, which was able to turn around decades of subnational fiscal indiscipline since the introduction of the law in 2000. The data provided by Table 4 also indicate that Argentina and Colombia registered important improvements of subnational fiscal behaviour in the years since 2001/2002, after extended periods of fiscal crisis and turmoil. In the case of Argentina, though, these improvements can hardly be attributed to the fiscal responsibility law passed in 2000, before the peso crisis that brought Argentina at the brink of collapse. At any rate, it seems fair to assume that in most cases the public commitment of national and subnational governments to good financial governance has played a positive role in the complex negotiation and reform processes that have led to the current, more favourable situation of public finance in the region.

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42 See Webb (2004); Kopits (2007) for in-depth discussions of fiscal responsibility laws.

43 Fiscal stabilization funds where introduced by a number of countries, such as Argentina, Ecuador and Chile, but so far their use as instruments of countercyclical fiscal policy has been limited.

5 Conclusion

This paper has discussed the conceptual relationships of taxation, fiscal decentralization and social cohesion. It has argued that an active promotion of social inclusion and equity can be facilitated by a tax system that possesses the following characteristics: (i) a broad tax base (horizontal equity), (ii) a reasonable degree of nominal progression (vertical equity), usually achieved through direct taxes on income and property, and (iii) a fiscal decentralization regime based on the principles of market-preservation, fiscal equivalence and accountability. Also, the discussion has highlighted the importance of counterbalancing territorial and social heterogeneity through fiscal compensation schemes and of diminishing the volatility of tax revenue through countercyclical measures. Apart from economic motivations, the paper has stressed the relevance of social (equity) and political (legitimacy) factors in establishing a tax system geared towards social cohesion.

The situation in Latin America differs considerably from the ideal-type model sketched out above. As could be seen, the level of taxation and the composition of the tax structure are not particularly conducive to an active promotion of social cohesion. The polarization of wealth and income goes hand in hand with a tax system where the upper strata of society systematically avoid contributing their fair share to the provision of public goods. At the same time, the available information on fiscal decentralization suggests that in most cases local or intermediate governments do not have strong incentives to engage in market-friendly policies or to strengthen responsiveness vis-à-vis local interests.

Since 2003/2004, high economic growth rates in combination with rising world market prices for commodities and a high liquidity of international financial markets have contributed to a rather comfortable fiscal situation in almost all the countries of the region. While some organizations, such as ECLAC and IDB,[44] tend to regard the current situation as a window of opportunity for the negotiation of new fiscal pacts and the implementation of reforms, there is a certain risk that Latin American policy-makers might prefer the soft option of enjoying the current *bonanza* without laying the groundwork for future fiscal sustainability. Crucial measures in the latter sense would have to include a tight control of expenditure at all levels of government, a further increase of direct taxes – especially those levied on personal income and property – and in most cases a strengthening of local and intermediate tax collection so as to enhance fiscal equivalence.

These measures would be mostly in line with the approaches of international organizations and bilateral donors. For example, in its 2005 policy paper "Promoting Social Cohesion in Latin America", the European Commission recommends a total of eleven policy measures. Among these, the following points refer to fiscal policy in general and taxes in particular:

— *"Reducing macroeconomic instability, in particular by diminishing the strong procyclical bias shown by fiscal policies in LA" (...),*

— *"In countries with relatively low tax-over-GDP ratios, taking measures to increase those ratios, (...) not by raising tax rates (...) but by widening the tax bases, fighting tax evasion (which can, in itself, have a positive impact on equity) and strengthening tax administration."*

44 For instance, see ECLAC (2007c, 6); IDB (2007,1).

— *"In some cases, there may be a case for making tax systems more progressive by increasing the weight of direct income taxation."* (European Commission 2005, 6–8)

From the findings presented in this paper, this list would have to be completed, mostly by adding policies geared towards improved fiscal decentralization and equality in public goods provision. At any rate, it remains to be seen whether Latin American governments will be able to muster the necessary support for the implementation of these changes. While many social forces have come to appreciate the advantages of responsible fiscal management (not least, the private sector), rising social demands may push governments towards releasing their grip on expenditure without taking the necessary steps at the revenue side of public finance.

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