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The Politics of Revenue-Raising Tax Reform in Latin America

by

Tasha Ann Fairfield

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Committee in charge:

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Professor Kent Eaton

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Spring 2010

The Politics of Revenue-Raising Tax Reform in Latin America  
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Abstract

The Politics of Revenue-Raising Tax Reform in Latin America

by

Tasha Ann Fairfield

Doctor of Philosophy in Political Science

University of California, Berkeley

Professor Ruth B. Collier, Co-Chair

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Increasing tax revenue is imperative for development and good governance in Latin America. Governments throughout the region experienced continued revenue needs in the aftermath of market-oriented tax reforms implemented in the 1980s and early 1990s, yet tax policy outcomes varied widely, across countries, over time and across tax policy areas.

This study explains variation in governments' tax reform agendas and the fate of reform proposals in Chile, Argentina, and Bolivia by analyzing the power of business, a key actor in tax politics in highly unequal societies. Many taxes directly or indirectly affect profits, and business associations may defend the interests of upper-income individuals as well as corporations. The classic concepts of *structural power* and *instrumental power* elaborate distinct means of business influence. Structural power arises from a perceived threat that a policy will lead to inadequate investment via market signals. Instrumental power entails deliberate political actions. Sources of instrumental power include relationships with decision-makers and resources that help business pressure policymakers more effectively. When either type of power is strong, taxing elites will be difficult, and reforms that policymakers view as desirable may even be eliminated from the agenda.

In Chile, strong instrumental power kept significant tax increases off the agenda. Weaker business power in Argentina gave governments more leeway to increase taxation at the cross-sectoral level, although some powerful sectors prevented tax increases with sector-specific impact. Bolivia is a rare case where business's substantial power was challenged by counter-mobilization on tax issues and a radical threat from popular sectors to the existing political and economic system.

The analysis is based on 82 tax proposals embedded in 48 reform packages. Cases in which policymakers decided not to propose tax reforms they viewed as important are also examined. Primary data sources include interviews with high-level government and tax agency officials, politicians, and business leaders, as well as congressional records, newspaper articles, tax agency reports, and tax return statistics.

This research provides insights on building state extractive capacity, which has received insufficient attention in political science. It also contributes to theory on business politics by specifying mechanisms through which economic elites influence policy in democratic societies, observable sources of their power, and government strategies that can attenuate their influence on taxation.

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## Acronyms

ABA	Asociación de Bancos de la Argentina
ABIF	Asociación de Bancos e Instituciones Financieras, Chile
ADEBA	Asociación de Bancos Argentinos
ADN	Acción Democrática y Nacionalista, Bolivia
AEA	Asociación Empresaria Argentina
AFIICH	Asociación de Fiscalizadores de Impuestos Internos de Chile
AFIP	Administración Federal de Ingresos Públicos, Argentina
ASOBAN	Asociación de Bancos Privados de Bolivia
CAMARCO	Cámara Argentina de Construcción
CAC	Cámara Argentina de Comercio
CADEX	Cámara de Exportadores de Santa Cruz, Bolivia
CAINCO	Cámara de Industria y Comercio de Santa Cruz, Bolivia
CARBAP	Confederación de Asociaciones Rurales de Buenos Aires y La Pampa
CAO	Cámara Agropecuario del Oriente, Santa Cruz, Bolivia
CBH	Cámara Boliviana de Hidrocarburos
CChC	Cámara Chilena de la Construcción
CEP	Centro de Estudios Públicos, Chile.
CEPAL	Comisión Económica para América Latina y el Caribe
CEPB	Confederación de Empresarios Privados de Bolivia
CERC	Centro de Estudios de la Realidad Contemporánea, Chile.
CIARA	Cámara de la Industria Aceitera de la República Argentina
CIPPEC	Centro de Implementación de Políticas Públicas para la Equidad y el Crecimiento, Argentina
CNC	Cámara Nacional de Comercio, Bolivia
CNC	Cámara Nacional de Comercio, Chile
CNI	Cámara Nacional de Industrias, Bolivia
COB	Central Obrera Bolivia
CODELCO	Corporación Nacional del Cobre, Chile
CONINAGRO	Confederación Intercooperativa Agropecuaria, Argentina
COPAL	Coordinadora de las Industrias de Productos Alimenticios, Argentina
CPC	Confederación de la Producción y del Comercio, Chile
CPCE	Consejo Profesional de Ciencias Económicas, Argentina
CRA	Confederaciones Rurales Argentinas
CSA	Cámara de Sociedades Anónimas, Argentina
DNIAF	Dirección Nacional de Investigaciones y Análisis Fiscal, Argentina
ECTCU	European Commission Taxation and Customs Union
FAA	Federación Agraria Argentina
FEPB-SC	Federación de Empresarios Privados de Bolivia-Santa Cruz
FIEL	Fundación de Investigaciones Económicas Latinoamericanas, Argentina
FPV	Frente para la Victoria, Argentina
INE	Instituto Nacional de Estadística de Bolivia
MAS	Movimiento al Socialismo, Bolivia
MECON	Ministerio de Economía y Producción, Argentina
MIR	Movimiento de Izquierda Revolucionaria, Bolivia
MNR	Movimiento Nacionalista Revolucionario, Bolivia
PDC	Partido Demócrata Cristiano, Chile
PJ	Partido Justicialista, Argentina
PODEMOS	Poder Democrática Social, Bolivia
PPD	Partido Por la Democracia, Chile

PRDS	Partido Radical Social Demócrata, Chile
PS	Partido Socialista, Chile
RN	Renovación Nacional, Chile
SBIF	Superintendencia de Banco e Instituciones Financieras, Chile
SEGPRES	Ministerio Secretario General de la Presidencia, Chile
SII	Servicio de Impuestos Internos, Chile
SIN	Servicio de Impuestos Nacionales, Bolivia
SNA	Sociedad Nacional de Agricultura, Chile
SOFOFA	Sociedad de Fomento Fabril, Chile
SONAMI	Sociedad Nacional de Minería, Chile
SRA	Sociedad Rural Argentina
UCR	Unión Cívica Radical, Argentina
UDI	Unión Democrática Independiente, Chile
UIA	Unión Industrial Argentina
UN	Unidad Nacional, Bolivia

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## Chapter 1. Introduction

Increasing taxation is widely acknowledged as imperative for development and redistribution in Latin America, a region known for its weak tax capacity and extremely high levels of inequality.<sup>1</sup> Weak tax capacity jeopardizes the ability to maintain fiscal discipline, manage economic downturns, and invest in human capital and poverty reduction; aggregate tax revenue in the region is insufficient to support adequate social spending (Bird 2003, World Bank 2004, Perry et al. 2006, Sabaini et al. 2006). Because income distributions are so top-heavy, raising revenue by definition entails taxing the resources of economic elites. In particular, highly concentrated income and profits constitute a major, under-tapped tax base in Latin America. Taxing economic elites more heavily can also contribute to redistribution, which many have argued promotes democratic stability (Karl 2000, Acemoglu and Robinson 2001) and economic growth (Alesina and Rodrik 1994, Birdsall and Londoño 1997, López 2003, World Bank 2004, Chapter 1). Not only can progressive taxation generate more revenue for targeted social spending, but it can also make a direct contribution to redistribution (Chu et al. 2000, Saez 2001, Zee 2004, Sabaini et al. 2006, Barreix et al. 2006). Many tax systems in the region are instead regressive, worsening the distribution of income (Chu et al. 2000, Sabaini et al. 2006, Cantallopis et al. 2007). Yet taxing economic elites is a difficult challenge, since they are often well-positioned to prevent reform.

Despite the importance of taxation—not just for funding social spending (Haggard and Kaufman 2008: 356), but for maintenance of all state functions—tax reform in Latin America has been understudied from the perspective of political science. Economists who have written about tax policy in Latin America either do not address or do not adequately analyze the politics of reform (Gillis 1989, Bird 1992, Thirsk 1997, Lora 2007). A few political scientists have analyzed market-oriented tax reforms legislated in the 1980s and early 1990s,<sup>2</sup> but for the most part the literature on structural adjustment in Latin America does not disaggregate taxation from the larger set of reforms that were widely promoted during that period. Privatization and trade liberalization, in contrast, have received much more attention as distinct policy areas. Moreover, little has been written on subsequent tax reforms of the late-1990s and 2000s, which include reforms of a different type: increasing taxes that target the resources of economic elites, as opposed to increasing regressive consumption taxes.

Significant variation in tax reform proposals and outcomes can be observed across countries, as well as across tax policy areas in Latin America in the aftermath of market reforms. Consider Chile and Argentina, two countries that relied heavily on consumption taxes by the early to mid 1990s. Governments in both countries repeatedly sought to increase taxation to meet growing revenue needs, but while Chile made little progress, Argentina achieved major advances. Chile's corporate tax rate remained the lowest in Latin America despite modest reforms in 1990 and 2001, and efforts to close the most important loopholes were blocked. Consequently, corporate tax revenue held essentially constant from 1993 to 2005 at an average of 2.5% GDP. In contrast, successive reforms in Argentina after 1992 increased the corporate tax rate to the highest in the region. These rate increases, along with reforms to close loopholes, contributed to a gradual increase in corporate tax revenue from 1.3% GDP in 1992 to 3.7% GDP in 2005. Expanding tax agency access to bank information, which is critical for ensuring that elites do not evade taxes by under-declaring assets, proved impossible in Chile; the most important deposits remained protected by banking secrecy in 2009. But Argentina's tax agency obtained full, automatic access to bank information in 2006, making it remarkably powerful. In fact, the historically weak Argentine tax agency is now more powerful than its Chilean counterpart—which was long considered by far the best in Latin America—not only in terms of bank information access, but also in terms of regulating transfer pricing and controlling sophisticated forms of VAT evasion. Likewise, while Chile passed only marginal tax increases on the under-taxed but highly profitable copper-mining sector,

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<sup>1</sup>See for example World Bank (2004: 9-46): “most countries in the region raise inadequate levels of taxes. ...many countries in Latin America still have levels of taxes significantly below what is needed to support rapid social and economic development and efficient redistribution, and less than prevailing levels in countries in other regions with similar levels of income per capita.”

<sup>2</sup>See for example Durand 1994, Weyland 1996, Durand and Thorp 1998, Eaton 2002, Mahon 2004, Arce 2005.

Argentina imposed high taxes on agricultural exports after 2001 to tap windfall profits from international price increases and currency devaluation.

Variation can be also observed within countries across tax policy areas and over time, particularly in Argentina. Despite Argentina's more substantial progress in the above policy areas compared to Chile, Argentine governments were unable to eliminate a costly income tax exemption for interest earnings that benefited upper-income individuals. Expanding tax agency access to bank information proved impossible during the 1990s, but reform proceeded without difficulty after the 2001 economic crisis. And whereas the agricultural sector failed to deter regular export tax increases from 2003 to 2007, a massive producers' protest forced the Argentine government to overturn an export tax increase in 2008.

Examining business influence is critical for explaining variation in the type, timing, and outcome of tax reforms proposed in these countries. Business, whether organized in associations or in the form of individual firms and investors, is a key actor in tax politics. Many taxes directly affect profits and investment behavior. Moreover, business associations may defend the class interests of upper-income individuals as well as the interests of corporations. Non-business actors like labor unions or popular sector organizations may also be important in tax politics, but most of the variation in tax policy outcomes examined in this study can be explained by focusing on business.

Accordingly, my analysis employs the classic concepts of business's *instrumental power* and *structural power*, which correspond to different means of influence. Instrumental power is exercised through deliberate political actions, like lobbying. Structural power stems from individual investment decisions, coordinated by market signals. This form of power acts through a perceived threat that a reform will lead to reduced investment or other negative macroeconomic outcomes. This classic business power framework has not been systematically applied in the literature on economic reforms in Latin America, yet it provides an elegant and analytically insightful way to encompass a wide range of causal processes that affect reform outcomes. I refine this framework by classifying observable sources of business power, identifying how they can vary, not only across countries, but also over time, across sectors, and across policy areas, and specifying the ways in which instrumental power and structural power can be mutually reinforcing.

I argue that business power creates overarching constraints that delineate the extent to which tax reform is possible. When either instrumental power or structural power is strong, increasing taxation of elites will be difficult. Strong business power may even remove reforms that a government views as desirable from the agenda. However, various strategies can help reform-minded governments increase taxation at the margins when business power is strong.

Drawing on literature on welfare states and taxation as well as empirical case evidence, I develop a typology of government strategies for circumventing business power and building support for tax increases that require approval in congress. These strategies may act by reducing business opposition to reform, by mobilizing public support for reform in order to counter-balance business pressure on politicians, or by reducing concern regarding the effect of reform on investment. The strategies I identify are often closely associated with the choice of particular tax policy instruments or the design of a broader reform package. While strategy choice can be important, I emphasize that it tends to be secondary to business power for understanding the extent to which it is possible to tax economic elites.

In Chile, I argue that business's strong instrumental power kept the most important reforms for increasing taxation of elites off the agenda following the transition to democracy, even in the absence of structural power. However, the governing coalition that occupied the executive branch since 1990 developed a broad repertoire of strategies to facilitate incremental revenue-raising reforms. Nevertheless, total tax revenue in Chile held essentially constant from 1995 to 2005, despite the fact that top leaders in the governing coalition wanted more tax revenue in order to fund a more ambitious social agenda.

Overall, business power in Argentina was much weaker than in Chile. Administrations that sought to increase taxation of elites therefore had more leeway to do so than in Chile. Accordingly, Argentina made more substantial progress than Chile in key policy areas including corporate taxation and bolstering the tax agency's auditing powers. Reforms in these and other tax policy areas contributed to a phenomenal increase in total tax revenue in Argentina from 1995 to 2004 of almost 8 percentage points of

GDP, the largest increase observed in Latin America; the average revenue increase in the region was less than 2 percentage points of GDP (Sabaini 2005: 7). Nevertheless, some sectors, including finance and agriculture, enjoyed instrumental and/or structural power at given times that allowed them to block or reverse tax reforms with sector-specific impact.

The main contributions of this study lie in identifying and classifying the means and mechanisms through which economic elites influence policy, sources of variation in their power, and factors that can attenuate their influence. I do so by employing the classic theoretical framework of business power in conjunction with process-tracing based on empirical case evidence. This research contributes to our understanding not only of prospects for building tax capacity in Latin America, but also prospects for redistribution more broadly in highly unequal societies.

### **First-Generation Tax Reforms and their Aftermath**

In the late 1980s and early 1990s, Latin America undertook major tax reforms based on free-market principles advocated by neoliberal economists. These tax reforms often formed part of broader economic stabilization packages designed to remedy the disastrous consequences of the debt crisis of the 1980s, which afflicted countries throughout the region.

This wave of “first generation” tax reforms emphasized neutral and efficient<sup>3</sup> indirect taxes, establishing the value-added tax (VAT)—a sales tax collected from businesses but ultimately paid by consumers—as the central revenue-raising engine.<sup>4</sup> The average VAT rate in the region increased from around 11% when first introduced in the 1970s and 1980s to 12% in 1992 and 14% in 2000 (Sabaini 2005: 23). Meanwhile, VAT bases were broadened to include more goods and services. VAT revenue accordingly increased to 3.6% GDP in the early 1990s and 4.9% GDP in the late 1990s, helping to reestablish fiscal solvency in the region. In Chile and Argentina, VAT revenue as a percent of GDP reached levels collected by developed countries by the mid 1990s. In the interest of economic efficiency, meanwhile, high tax rates on income and profits, which states had not effectively collected in practice, were cut. The average top personal income tax rate fell from 50% in 1986 to 35% in 1992 and 29% in 2000, and the average top corporate income tax rate dropped from 44% to 35% in 1992 and 29% in 2000 (Sabaini 2005: 33, 35).

First generation reforms, however, did not solve Latin America’s tax problems. On the one hand, tax revenue remained insufficient despite substantial increases. Even in countries where revenue was not particularly low in comparative perspective, governments sought additional revenue to satisfy growing demands on state coffers; insufficient tax revenue often jeopardized fiscal discipline and/or constrained social spending. On the other hand, tax systems remained regressive, making income distributions more unequal rather than more equitable prior to government spending.

### **Continued Revenue Shortfalls**

Although first-generation reforms contributed to substantial revenue increases, aggregate taxation in Latin America remained quite low, averaging 16% of GDP during the mid-1990s. Average tax revenue in the European Union, in contrast, amounted to 41% of GDP (Figure 1.1). Tax revenue in Latin America was low not only compared to developed countries, but also controlling for the level of development. There is a well-known positive empirical relationship between per capita GDP and tax revenue as a percent of GDP; tax revenue in most Latin American countries fell well below the worldwide regression line in the 1990s (Figure 1.3). A similar empirical relationship holds between tax revenue and GDP per capita calculated at purchasing price parity; again, most Latin American countries fall well below the worldwide regression line (Mahon 2009a). In practice, tax revenue in Latin America proved insufficient to meet growing government needs and could not support social spending at levels adequate for the

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<sup>3</sup>In other words, taxes that do not distort investment and/or consumption decisions.

<sup>4</sup>For further discussion of tax reforms that accompanied structural adjustment in Latin America, see Thirsk 1997, Lledo, Schneider and Moore (2004: 33-39) and Lora (2007).



challenge of reducing the region's persistent poverty and inequality (World Bank 2004: 9.46; Perry et al. 2006: 95-7; Sabaini et al. 2006: 23, Barreix et al. 2006: 51, 56).

Latin America's shortfall in tax revenue is due primarily to under-taxation of income and profits (Figure 1.1, 1.2). On average, direct tax revenue in the 1990s fell below levels predicted by GDP per capita by 3.4 percentage points of GDP (Perry et al. 2006: 96). Direct tax revenue shortfalls in Chile and Argentina both exceeded 5 percentage points of GDP. In contrast, revenue from taxes on goods and services (VAT and other sales taxes) on average fell squarely on the predicted regression line. While some countries still had room for substantial increases in revenue from consumption taxes, a number of countries fell above the regression line; Chile's revenue from taxes on goods and services exceeded the predicted level by 2.9 percentage points of GDP. By the mid-1990s, revenue from taxes on goods and services in both Chile and Argentina exceeded regression predictions based on GDP per capita at purchasing power parity as well: by 1.7 and 0.9 percentage points of GDP, respectively. Most of the direct tax revenue shortfalls are associated with individual income taxes, although corporate tax revenue is also low (Figure 1.2).

**Figure 1.1: Average Tax Revenue, % GDP, 1995-1999**

	EU-15†	Latin America††	Chile <sup>a</sup>	Argentina <sup>o</sup>
<b>Total Tax Revenue With Social Security Contributions</b>	41	16	16	17
<b>Total Tax Revenue Without Social Security Contributions</b>	29	13	16	13
<b>VAT</b>	7.2	5.1*	8.0	6.9
<b>Direct Taxes</b>	15	3.0	3.6	3.0
<b>Personal</b>	11	0.9	1.2	1.1
<b>Corporate<sup>oo</sup></b>	3.1	2.0**	2.3	1.8

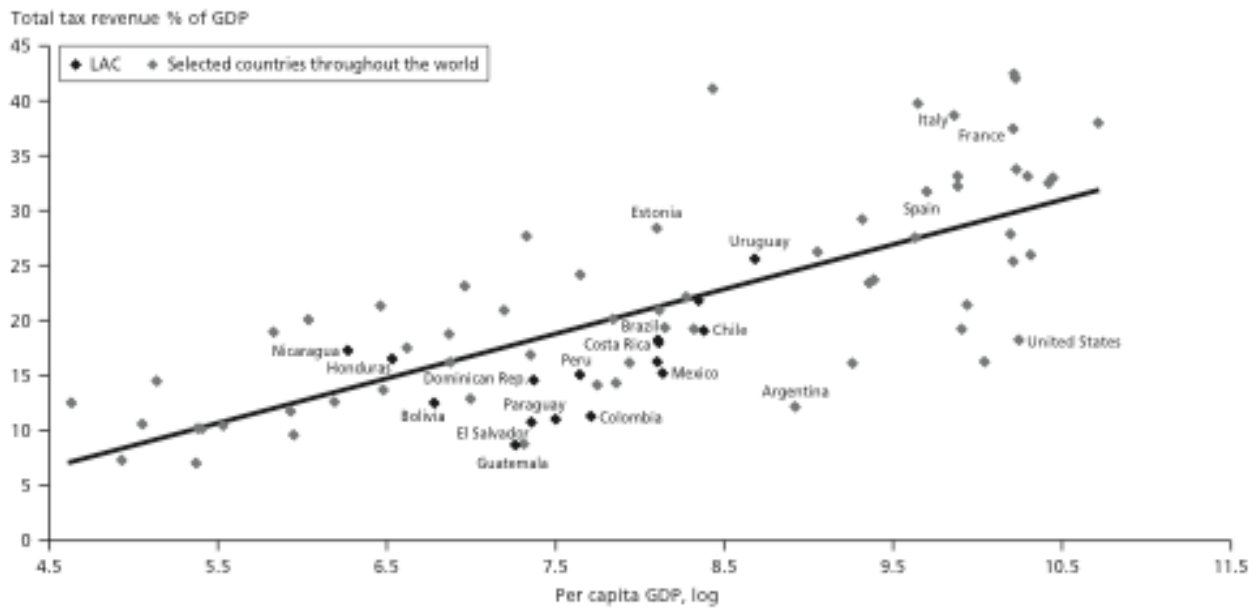
†ECTCU (2006: 215, 218, 226, 230, 234) ††Sabaini (2005: 6, 26, 32, 36), excluding Haiti. <sup>a</sup>SII 2006 <sup>o</sup>DNIAF 2007 (total tax revenue collected by central government before transfers to provinces) \*Includes other consumption taxes as well. Calculated with data from SIN, SII, DNIAF, SUNAT, Stotsky and WoldeMariam (2002: 8). \*\*2002 value. <sup>oo</sup>Europe relies primarily on individual income taxes, but corporate tax revenue per GDP exceeds Latin American averages by about 50%.

**Figure 1.2: Differences Between Actual and Predicted Tax Revenue (% GDP)**

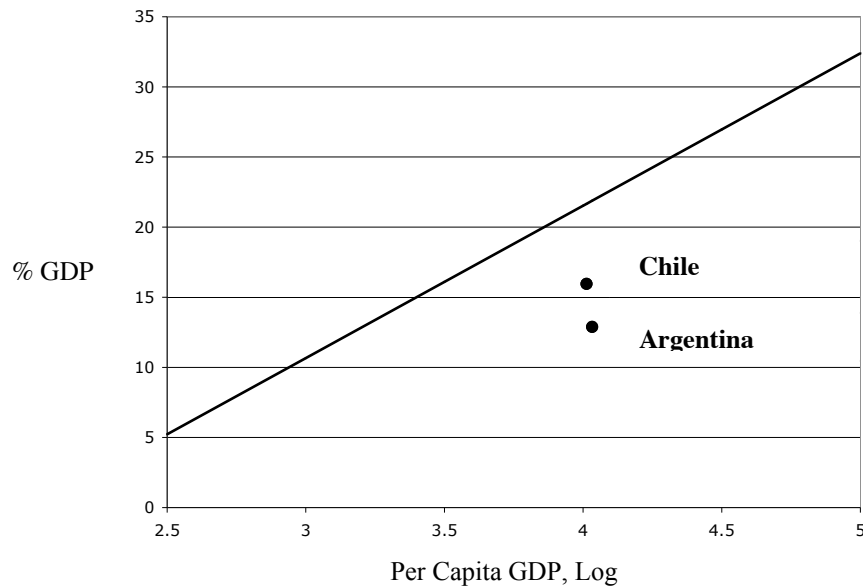
	Regression Line Predictor					
	GDP per capita 1990s*			GDP per capita, PPP, 1995-99**		
	Chile†	Argentina††	Latin America	Chile†	Argentina††	Latin America
<b>Total Tax Revenue</b> (excludes social security)	-3.6	-12.3	-4.4	-5.7	-9.0	
<b>Taxes on Goods and Services</b>	+2.9	-3.4	-0.3	+1.7	+0.9	-1.9
<b>Direct Taxes<sup>oo</sup></b>	-6.4	-5.6	-3.4	-3.4	-5.1	
<b>Personal Income Tax</b>	-4.0	-4.4	-2.7	-3.3	-4.5	
<b>Corporate Taxes</b>	-2.4	-1.2	-0.7	-0.1	-0.6	

\*Perry et al 2006: 96. Latin American averages for taxes on goods and services and direct taxes exclude Honduras (no data). Latin American corporate tax average excluding Venezuela, which over-collects by 6% GDP, is -1.1. †SII 2006 †† DNIAF 2007 (total tax revenue collected by central government before transfers to provinces) \*\*Mahon 2009b, personal communication. Mahon's uses World Bank and IMF data. However, my figures compare Mahon's regression line to SII and DNIAF data, which I judge more reliable for Chile and Argentina. <sup>oo</sup>Summing personal income tax and corporate tax shortfalls.

**Figure 1.3: Tax Revenue, % GDP, vs. Log Per Capita GDP, 1990s**  
 Source: Perry 2006: 95

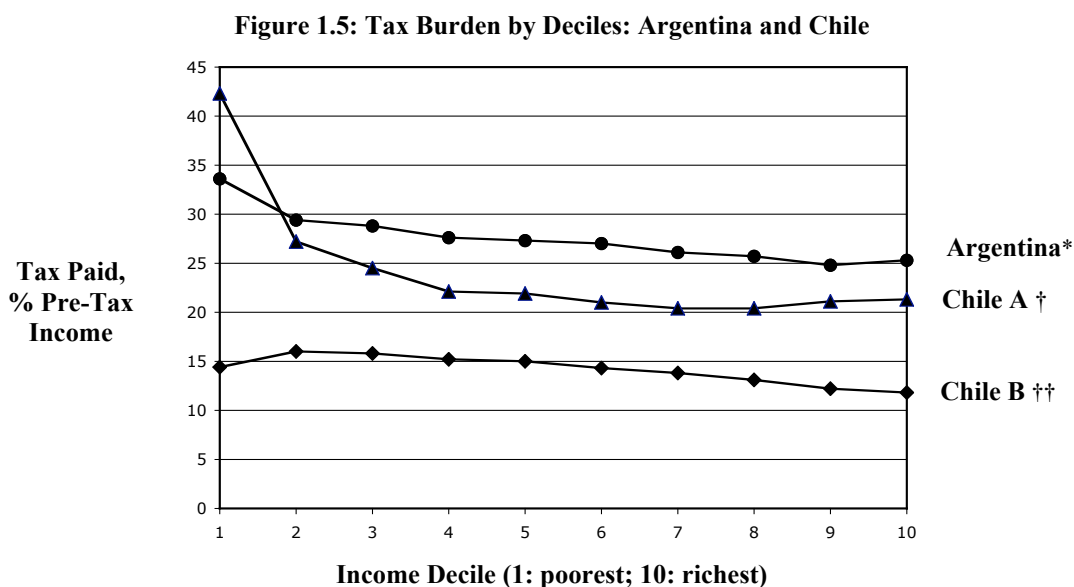


**Figure 1.4: Tax Revenue, % GDP, vs. Log Per Capita GDP at Purchasing Power Parity, 1995-99**  
 Sources: DNIAF, SII; Regression line: Mahon 2009b (personal communication)



## Regressive Tax Systems

Tax systems not only failed to meet growing revenue needs in the aftermath of first-generation reforms, but they also tended to be regressive, worsening rather than improving the distribution of income prior to government spending.<sup>5</sup> This problem reflected heavy reliance on consumption taxes and minimal taxation of income and profits. Consumption taxes tend to be regressive—that is, the poor pay more taxes in proportion to their income than rich—because the poor spend a larger fraction of their income.<sup>6</sup> Direct taxes in contrast tend to be progressive. Personal income taxes in Latin America place a much larger burden on the rich than on the poor because marginal tax rates generally increase with income brackets and because minimum allowances exempt the vast majority of citizens, who have very little taxable income. Corporate taxes tend to be less progressive than individual income taxes, because the burden may be passed on to labor or consumers through wages and prices. However, capital owners, who constitute a tiny elite, are usually assumed to bear a substantial portion of the burden.<sup>7</sup> Piketty and Saez (2006: 33) for example emphasize in their analysis of the US tax system that “capital income is very concentrated and hence taxes falling primarily on capital income such as the corporate income tax... have a sizeable impact only in small groups at the top of the income distribution.”<sup>8</sup> Sabaini et al (2002: 22, 60, 64) find that Argentina’s corporate tax is progressive, with the top decile bearing twice the burden of the bottom quintile, based on the assumption that 50% of the corporate tax burden falls on capital owners and 50% on consumers. And Cantallopis et al. (2007: 26) find that the corporate tax in Chile is progressive, assuming that the tax burden falls upon capital owners (see Chapter 3 for more detail).



\*Gaggero and Sabaini (2002: 128) 1997 data.

†Cantallopis et al. (2007: 25). 2003 data. Imputes corporate tax and reinvested corporate profits to their owners.

††Engel et al. (1999: 172). 1997 data. Excludes the corporate tax and reinvested corporate profits from analysis.

<sup>5</sup>First-generation reforms probably did not make tax systems more regressive than they already were in practice. However, reliance on consumption taxes did little to solve the problem of regressivity.

<sup>6</sup>The VAT is less regressive in practice when the informal sector is composed primarily of poor vendors and consumers who evade the tax (Cossio 2006).

<sup>7</sup>Corporate tax incidence assumptions employed by economists vary widely, from assigning the corporate tax entirely to capital owners, to dividing it equally among capital owners and wage earners (or wage earners plus consumers) (see for example Sabaini et al 2002: 25). Piketty and Saez (2006: 10) assign the corporate tax to individuals in proportion to their income from capital of all forms, including pensions. This method constitutes an intermediate approach between assigning the corporate tax entirely to shareholders and assuming that it is entirely passed on to labor income.

<sup>8</sup>Piketty and Saez (2006) find that in 1997, the top 5% of taxpayers bore twice the corporate tax burden of the bottom quintile, and the top decile bore 1.7 times the burden of the bottom quintile.

Tax systems in Argentina and Chile were regressive by all accounts in the late 1990s. VAT revenue along with other sales taxes accounted for fully 52% of total tax revenue collected by the central state in Argentina (including social security taxes) and 61% in Chile on average from 1995 to 1999, while taxes on income, profits, and wealth accounted for only 18% and 23%, respectively (SII 2006, DNI AF 2007). Figure 1.5 displays the total tax burden (tax paid as a proportion of income) by income deciles in Argentina and Chile according to three different incidence studies. While these studies are not comparable because they employ different methodologies and different definitions of income, in each case, the poorest decile pays a significantly larger tax burden than the richest decile.

### **The Rationale for Progressive Taxation**

Economists expressed little concern over tax equity while first-generation reforms were underway, and the predominant view within the discipline and in the development community remains that equity should be of little concern in designing tax systems. The VAT was lauded as easy to administer, economically efficient, and capable of generating major quantities of revenue. Progressive direct taxes on income and profits in contrast are condemned as distortionary, inefficient, and difficult to collect from the point of view of tax administration and evasion (Engel et al. 1999: 182). These analysts made much of failed prior attempts to effect redistribution through taxation in Latin America—tax systems that had appeared highly progressive on paper in practice failed to extract substantial amounts of revenue from economic elites. In addition, they argued that spending has a much greater impact on redistribution than taxation (Engel et al. 1999, Lora 2007). Instead of pursuing progressive taxation, most economists assert that redistribution should take place through government spending alone. The standard prescription is for governments to raise revenue as efficiently as possible and subsequently target spending to the poor.<sup>9</sup> Indeed, the conventional wisdom asserts that progressive taxation is essentially irrelevant to equity.

However, a strong case can be made for increasing progressive taxes on income and profits, along with other reforms designed to directly tap the resources of economic elites. First, given the extreme inequality and concentration of income and wealth in Latin America, progressive taxation can be an effective and efficient tool for raising revenue. Second, progressive taxation can make a direct contribution of its own to redistribution.

### **Raising Revenue with Progressive Direct Taxes**

Progressive taxation can be an effective tool for raising revenue when the distribution of income is highly concentrated, a fact that is often overlooked in the economic and development literature on taxation. Building on research in optimal tax theory by Piketty (1997), Diamond (1998), and others, Saez (2001) demonstrates that very high marginal income tax rates can actually be optimal for raising revenue from upper-income individuals.<sup>10</sup> He derives marginal income tax rates as a function of earnings elasticities and the shape of the top tail of the income distribution (the Pareto distribution parameter). Using empirical estimates of these parameters for the case of the United States, Saez (2001: 213) finds that in order to maximize revenue raised from high-income earners, the top marginal tax rate should be set between 59% and 71%. Using a much simpler economic model with two individuals, one rich and one poor, Zee (2004) also finds that progressive taxation can be optimal for raising revenue. He concludes:

...the validity of the increasingly fashionable policy advice—maximizing neutrality in taxation and addressing the distributive objective primarily through expenditure policy—is questionable because it ignores the revenue-raising aspect of progressive

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<sup>9</sup>Engel et al (1999: 188) provide the standard statement of this prescription: “the tax structure should be chosen on the basis of tax collection and efficiency criteria, and not according to its redistributive merits. Distributional considerations should enter only when deciding the size of the overall tax burden. Once the amount to be redistributed is decided, which depends on the distributional preferences of society, the efficiency of redistributive programs and the extent to which expenditures are targeted to low-income households, revenue should be raised with the most efficient taxes and income inequality should be ameliorated through expenditures.” In the political science literature, Wilensky (1975: 93) and Steinmo (1993) express similar perspectives on taxation in advanced industrial democracies.

<sup>10</sup>Saez (2002) and Saez (2004b) arrive at similar conclusions by exploring optimal tax models under different conditions.

taxation. On the basis of a simple model in which the tax revenue is used exclusively to finance (perfectly) targeted transfers to the poor, ...not only would it be optimal to finance the targeted transfers with progressive taxation, but the optimal progressivity increases unambiguously with growing income inequality. (Zee 2004: 359)

Progressive taxation becomes less advantageous as the income level of the bottom deciles increases, in which case “a significant amount of revenue can be raised with a uniform tax rate,” (Zee 2004: 378). This observation coincides with fact that tax systems in a few European countries (Denmark, Sweden and Finland) are not progressive, but nevertheless raise large amounts of revenue (Barreix et. al. 2006: 52).

In Latin America, households in the bottom deciles of the income distribution are so poor, and inequality is so pronounced, that Saez’s and Zee’s conclusions in favor of progressive taxation are highly relevant. The bottom two quintiles (poorest 40%) in Latin America received only 7% to 12% of national income in 1999, excluding the historically more equitable Costa Rica and Uruguay (CEPAL 2007). As such, the bottom of the distribution contains very little taxable income indeed. Only 14% of VAT revenue in Argentina and only 18% in Chile originates from the poorest 40% of households (Gaggero and Sabaini 2002: 129, Cantallopis et al. 2007: 25). Even the middle class, defined as those households with per capita income of 75% to 125% of the median income, following Birdsall et. al. (2000), is comparatively poor. While these households received on average 32% of national income in the mid-1990s in high-income countries, they received only 13% in Latin America (Birdsall et al. 2000: 25). In contrast, the top decile of households in Latin American countries receives between 38% and 53% of national income (excluding Costa Rica and Uruguay) (CEPAL 2007). Figure 1.6 displays the income distribution by deciles in Chile and Argentina.

In fact, income and profits are extremely concentrated at the very top of the richest decile. Figure 1.7 displays shares of income and/or income and profits accruing to the top cumulative percentiles of the adult population in Chile and Argentina. I derived these estimates from income tax return data obtained from the respective tax agencies, applying innovative techniques developed by Piketty (2003), Saez (2004a) and others.<sup>11</sup> According to my estimates, the top 1% in Chile and Argentina receive a larger fraction of national income than the top 1% in any of the developed countries analyzed in Atkinson and Piketty (2009) (Figure 1.8). The top 1% in Chile receives between 22% and 30% of national income, depending on whether or not retained profits are imputed to their owners (the low estimate reflects rampant under-declaration of distributed profits). The top 1% in Argentina receives between 19% and 21% of national income. These shares correspond to between 10% and 19% of GDP in Chile and 11% of GDP in Argentina—a substantial tax base. In comparison, the top 1% of taxpayers in the US, which has the highest concentration of income among the developed countries analyzed in Atkinson and Piketty (2009), receives 17% of national income.

Figure 1.9 displays optimal top marginal income tax rates for high-income earners in Chile and Argentina derived by applying Saez’s (2001) formula to income distribution parameters calculated from tax return data for these two countries.<sup>12</sup> Assuming that elasticities are the same as in the US (around 0.2), the optimal top marginal income tax rate would be between 55% and 64% in Chile and between 56% and 59% in Argentina. These rates are substantially higher than prevailing marginal income tax rates in the two countries: 35% in Argentina (after 1998) and 40% in Chile (after 2002).<sup>13</sup>

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<sup>11</sup>Income distribution figures based on household surveys do not provide an adequate description of top income shares. On the one hand, the truly wealthy tend to be absent from these surveys, since they either do not fall into the samples or refuse to participate. On the other hand, when such individuals are included in samples and do participate, they are often excluded from analysis as extreme outliers. While income tax returns suffer from problems of under-reporting in developing countries, they nonetheless offer much better information about the income of the very rich. See Alvaredo 2007 and Székely and Hilgert 1999.

<sup>12</sup>The reported rates are adjusted for the presence of a VAT of 18% in Chile and 21% in Argentina (Saez 2001: 213). I calculate the Pareto distribution parameter in each case from tax return data obtained from the tax agencies.

<sup>13</sup>High marginal tax rates may encourage taxpayers to place capital income in off-shore bank accounts in order to evade taxes; the rates calculated above do not take into account this likely response. However, expanding tax agency access to bank information, including transfers of funds abroad, as well as international information exchange agreements, can help the tax agency detect undeclared assets and hence control such evasion schemes. See for example Owens (2007) and OECD (2000, 2007).

**Figure 1.6: Income Distribution, Chile and Argentina, 1999.**

Source: CEPAL (2008), based on national household surveys.

	Deciles		Quintiles			Deciles	
	1	2	2	3	4	9	10
<b>Chile</b>	1.2	2.3	7.0	11.0	17.9	15.5	45.1
<b>Argentina</b>	1.5	2.6	8.2	12.6	20.1	15.6	39.3

**Figure 1.7: Estimated Top Income Shares, Chile and Argentina, 2003**

Source: Author's calculations based on tax return data.

Cumulative Percentile*	Chile 2003†				Argentina 2003††
	Excludes Retained Profits		Includes Retained Profits		Excludes Retained Profits
	Not ** Adjusted	Adjusted to Natl Acnts	Not Adjusted	Adjusted to Natl Acnts	Not Adjusted
<b>Top 1%</b>	<b>22.4</b>	<b>26.1</b>	<b>29.8</b>	<b>29.8</b>	<b>18.6-21.0</b>
<b>0.1%</b>	<b>8.1</b>	<b>12.3</b>	<b>13.7</b>	<b>15.0</b>	<b>9.0-10.2</b>

\*Individuals over age 20.

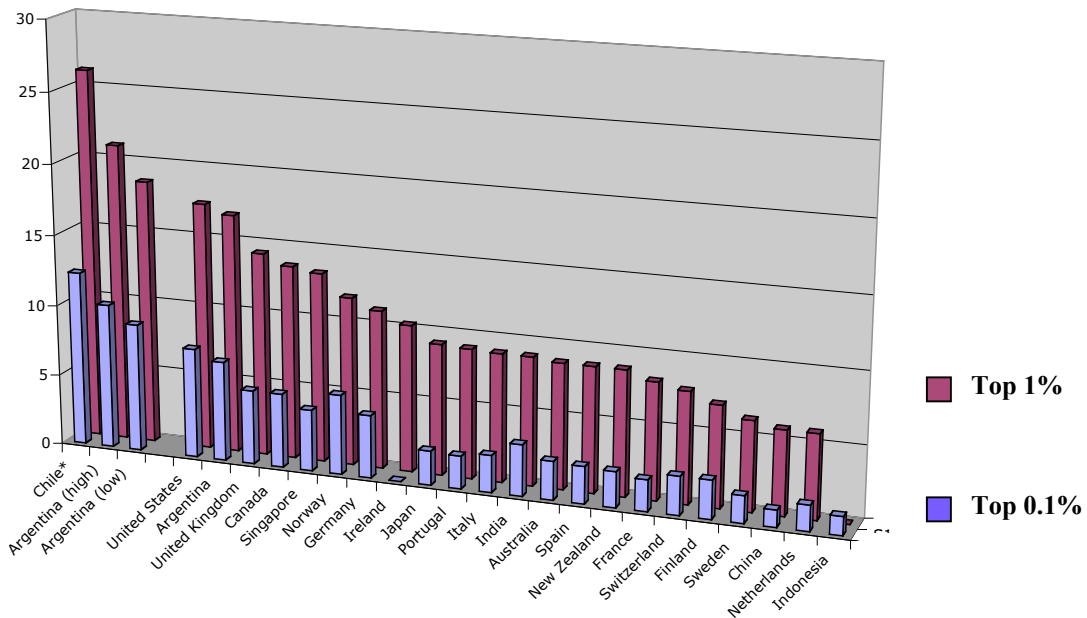
†Adjustment to National Accounts refers to distributed profits (capital income). Undeclared distributed profits were imputed to taxpayers with positive declared net profits (distributed and retained) in proportion to the declared amount. Author's calculations using Jorratt's database and Banco Central de Chile 2008.

††Author's calculations using AFIP 2004 and INDEC 2008. Figures differ from those reported by Alvaredo in Atkinson and Piketty (Figure 1.8 below) due to the latter's exclusion of tax-exempt but reported capital income. About 1000 dependent workers with high incomes are absent from tax statistics (AFIP A 2008, author's interview).

\*\*These shares are underestimates due to substantial under-declaration of distributed profits.

**Figure 1.8: Comparative Top Income Shares Worldwide**

Source: Author's calculations (first three on left); Atkinson and Piketty (2009: 78)



\*Excludes retained profits for comparability. Distributed profits adjusted to National Accounts.

**Figure 1.9: Optimal Top Marginal Income Tax Rates**

Source: Author's calculations based on Saez (2001: 212-213), Jorratt's Chilean tax return database, and AFIP 2004.

		EU = 0.2 EC = 0.2	EU = 0.2 EC = 0.5	EU = 0.5 EC = 0.5
<b>Argentina</b>	Wage Income	57-58%	48%	40-41%
	All Income	56-59%	46-52%	39-43%
<b>Chile</b>	Wage Income	55-56%	42-44%	37-38%
	All Income (including reinvested profits)	62-64%	55-58%	46-48%

EU = Uncompensated Elasticity

EC = Compensated Elasticity

**Figure 1.10: Effective Income Tax Rates, %, Chile and Argentina**

(Individual income tax and imputed corporate income taxes as a percent of total income)

Income Denominator Cumulative Percentile*	Chile 2003†				Argentina 2003††
	Excludes Retained Profits		Includes Retained Profits		Excludes Retained Profits
	Not ** Adjusted	Adjusted to Natl Acnts	Not Adjusted	Adjusted to Natl Acnts	Not Adjusted.
<b>Top 1%</b>	<b>17.4</b>	<b>11.2</b>	<b>11.9</b>	<b>9.5</b>	<b>14.8</b>
<b>0.1%</b>	<b>24.3</b>	<b>11.9</b>	<b>13.1</b>	<b>9.5</b>	<b>15.0</b>

\*Individuals over age 20.

†Adjustment to National Accounts refers to distributed profits (capital income). Undeclared distributed profits were imputed to taxpayers with positive declared net profits (distributed and retained) in proportion to the declared amount. Author's calculations using Jorratt's database and Banco Central de Chile 2008.

††Author's preliminary estimates using AFIP 2004 and INDEC 2008. Due to data limitation, results are fairly sensitive to assumptions made regarding imputation of corporate income tax. Future work will elaborate these issues.

\*\*These estimates are inflated due to substantial under-declaration of distributed profits.

**Figure 1.11: Comparative Effective Income Tax Rates, %**

(Individual and corporate taxes, excluding payroll taxes, federal taxes only, unless otherwise specified)

Percentile	Chile 2003†	Argentina 2003††	United States 2004*		France 2005**	
			Income Taxes	Income and Estate Taxes	Individual Income Taxes	Individual Income, Wealth, and Estate Taxes
<b>99.5-99.9</b>	11.2-13.4	16.1	28.1	30.0	16.4	21.5
<b>99.9-99.99</b>	~12.0-15.5	15.9	30.0	32.4	22.3	31.2
<b>99.99-100</b>	~8.9-12.5	13.5	30.8	33.3	28.8	53.0

†Author's calculations using Jorratt's database and Banco Central de Chile 2008. Low estimates corresponds to an income denominator including retained profits adjusted to National Accounts. High estimates corresponds to income denominator including unadjusted retained profits. Rates corresponding to an income denominator including unadjusted distributed profits and excluding retained profits are substantially higher (24.3% for the highest bracket).

†† Author's preliminary estimates using AFIP 2004 and INDEC 2008.

\*Saez 2006: 54.

\*\*Saez 2006: 56, based on Piketty 2001. Excludes corporate tax (no data).

Effective tax rates in Chile and Argentina are also quite low in comparative perspective, which further illustrates the potential for increasing taxation of income and profits in Latin America. Figure 1.10 displays the effective tax rates (taxes as a percent of total income) paid by the top cumulative percentiles in Chile and Argentina. Estimates for the top 0.1% range from 9.5% to 11.9% in Chile (or if distributed profits are not adjusted for under-declaration, a high of 24%) and approximately 14.8% in Argentina. By comparison, in the US, the top 0.1% paid an average effective rate of 29% in federal income tax alone in 2004 (Piketty and Saez 2006: 51). Figure 1.11 displays effective income tax rates by percentiles in the US and France. Upper income percentiles pay a significantly higher tax burden in these two countries compared to Chile and Argentina. Estate taxes in the US (as well as state-level income taxes) and wealth taxes in France increase the burden on the rich even more. (Chile applies no such taxes; Argentina has a wealth tax, but incidence information is unavailable.)

One might still object that despite the theoretical advantages of progressive taxation for raising revenue, the practical difficulty of collecting such taxes eradicating the benefits.<sup>14</sup> However, my interviews with tax agency officials in Chile, Argentina, and Bolivia suggest that taxes on income and profits are often less difficult to collect than is generally assumed. Withholding regimes can dramatically reduce or entirely eliminate evasion. For example, when employers withhold income taxes from employee's wages, there is no opportunity for evasion. Withholding regimes can be applied to other forms of income as well, such as interest earnings or dividends. Requiring third-parties such as banks or employers to provide the tax agency with information on transactions and payments can help the tax agency detect evasion more effectively by cross-checking tax declarations against these records. Similarly, expanding tax agency access to bank information and signing information exchange agreements with tax agencies abroad can facilitate detection of undeclared assets held offshore. Moreover, tax administration has improved significantly in many Latin American countries since the late 1980s and early 1990s, such that effectively processing large amounts of information and controlling income tax evasion has become much more feasible. In fact, fighting VAT evasion can be as challenging as fighting income tax evasion in terms of informational demands and required administrative capacity.<sup>15</sup> That income and profits are so concentrated can in itself simplify the administrative problem; most countries in the region now have "large-taxpayer units" designed to monitor the individuals and businesses that make the largest contributions to tax revenue.<sup>16</sup> Further, many reforms that increase taxation of elites place no additional burden on the tax agency, but rather make its job easier. Reforms that close loopholes and eliminate exemptions fall into this category—the simpler the tax code, the easier it is to detect evasion. This discussion is not meant to deny the real challenges tax agencies face in enforcing progressive direct taxes, but rather to question the conventional wisdom that dismisses such taxes as inherently difficult to collect and hence undesirable as revenue-raising tools.

### **Progressive Taxation's Direct Contribution to Redistribution**

In addition to raising revenue, progressive taxation can make a non-trivial direct contribution to redistribution, which is arguably an important goal in highly unequal Latin America. Many economists have argued that inequality is detrimental for development. For example, inequality may interfere with poverty reduction (World Bank 2004: 1.12-1.14).<sup>17</sup> Inequality may also hinder economic growth (Alesina and Rodrik 1994, Birdsall and Londoño 1997, López 2003, World Bank 2004: 1.15–1.19, Ferreira and

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<sup>14</sup>Zee (2004: 378) in fact voices such caveats: "many legitimate considerations against highly progressive taxation (e.g., concerns about tax evasion) have been ignored in the analysis."

<sup>15</sup>Toye and Moore (1997: 74) make some similar points regarding the VAT.

<sup>16</sup>The IMF began to advocate large-taxpayer units beginning in the 1980s. Chile, Argentina, Bolivia, Peru, Venezuela, Mexico, and several Central American countries all have such units.

<sup>17</sup>In fact, Londoño and Székely (1997: 21) emphasize that "poverty in LAC [Latin America and the Caribbean] is to a large extent a distributive problem. ...if LAC had the distribution observed in Eastern Europe or South Asia, poverty would be practically eliminated."



Ravallion 2008).<sup>18</sup> Political scientists, meanwhile, have argued that inequality undermines democratic stability (Karl 2000, Acemoglu and Robinson 2001). Failure to improve equity as well as the material well-being of the majority may cultivate disillusionment with democratic institutions and democracy as a form of government (Diamond 1999, World Bank 2004: 1.11-1.12, Karl 2005). Indeed, public opinion polls in Latin America have found widespread discontent with high levels of inequality (World Bank 2004: 1.12, Latinobarómetro 2009: 42). Further, inequality may foster political violence and crime (Karl 2000, World Bank 2004: 1.20).

Empirical evidence from developed countries illustrates the redistributive potential of progressive direct taxation. Tax systems in all but three of the original European Union countries are progressive, reducing Gini coefficients prior to government spending (Figure 1.12). Canada's tax system also contributes substantially to redistribution, reducing the Gini coefficient from 0.42 to 0.31 (Bird 2003: 46). In fact, as Bird (2003: 40) observes, taxation is "one of the few ways in which the wealthy may be made less wealthy" in market societies (Bird 2003: 40).<sup>19</sup>

Pioneering studies of income distribution and tax incidence by Piketty, Saez, and their collaborators provide further evidence in support of the redistributive virtues of progressive taxation. These studies show negative correlations between top income tax rates and income shares accruing to high income earners in India, the US, and France. Banerjee and Piketty (2003) document an increase in the income share of the wealthiest 0.01% of India's population from 0.4% to 1.7% over the last two decades that corresponds to dramatic cuts in the top income tax rate, which fell from 70% in the early 1980s to 40% at the end of the 1990s. Saez (2004a: 1, 56) shows that in the US, the income share of the top 1% surged from less than 8% in the 1970s to over 17% in 2000, while top marginal personal income tax rates were slashed from 70% in the 1960s to 39% in 2000, after reaching a low of 28% during the Reagan years.

**Figure 1.12: Income Inequality Before and After Taxes, 2001**

Source: Barreix et. al. (2006: 52).

Country	Gini (x100)		Reduction	
	Before Tax	After Tax	Difference	Percent
<b>Austria</b>	<b>33.8</b>	<b>29.4</b>	<b>4.0</b>	<b>10.4</b>
<b>Belgium</b>	<b>41.9</b>	<b>38.6</b>	<b>3.3</b>	<b>8.0</b>
<b>Denmark</b>	<b>43.7</b>	<b>45.8</b>	<b>-2.1</b>	<b>-4.7</b>
<b>Finland</b>	<b>44.4</b>	<b>44.5</b>	<b>-0.1</b>	<b>-0.2</b>
<b>France</b>	<b>37.8</b>	<b>35.7</b>	<b>2.1</b>	<b>5.5</b>
<b>Germany</b>	<b>38.7</b>	<b>34.7</b>	<b>4.0</b>	<b>10.4</b>
<b>Greece</b>	<b>42.6</b>	<b>39.4</b>	<b>3.2</b>	<b>7.6</b>
<b>Holland</b>	<b>34.8</b>	<b>32.3</b>	<b>2.5</b>	<b>7.2</b>
<b>Ireland</b>	<b>47.8</b>	<b>45.3</b>	<b>2.5</b>	<b>5.3</b>
<b>Italy</b>	<b>42.8</b>	<b>40.6</b>	<b>2.1</b>	<b>4.9</b>
<b>Luxemburg</b>	<b>37.1</b>	<b>32.3</b>	<b>4.8</b>	<b>12.9</b>
<b>Portugal</b>	<b>44.4</b>	<b>40.6</b>	<b>3.9</b>	<b>8.7</b>
<b>Spain</b>	<b>42.1</b>	<b>37.9</b>	<b>4.2</b>	<b>10.1</b>
<b>Sweden</b>	<b>40.7</b>	<b>42.8</b>	<b>-2.1</b>	<b>-5.2</b>
<b>United Kingdom</b>	<b>47.1</b>	<b>46.1</b>	<b>0.9</b>	<b>2.0</b>
<b>EU-15</b>	<b>41.7</b>	<b>39.2</b>	<b>2.5</b>	<b>5.9</b>

<sup>18</sup>Some authors question this assessment (Forbes 2000, Banerjee and Duflo 2003); however, according to the World Bank (2004: 1.16): "While there is as yet no consensus throughout the economics profession on this question, it is probably fair to say that the balance of academic opinion leans toward the view that high levels of inequality in incomes or in assets are causally related to lower rates of growth in mean incomes."

<sup>19</sup>Wibbels and Arce (2003: 131) make this point as well: "history suggests fiscal policy can be an effective tool in addressing equity considerations; developed economies continue to use tax policy in exactly this way."

Although Saez (2004a: 32) finds that tax cuts alone cannot account for the astonishing increase in inequality in the US,<sup>20</sup> he suggests that the tax cuts may have been a precondition for this trend:

A ... pertinent question to ask is ... whether this surge in top wages could have occurred, had the tax structure remained the same as in the early 1960s, and the working rich had to pay in taxes more than three quarters of their compensation. It is plausible to think that the drastic reduction in top marginal tax rates, which started in the 1960s, opened the possibility of the dramatic increase in top wages that started in the 1970s, and accelerated in the 1980s and the 1990s.

In a similar vein, Piketty and Saez (2004: 14-16) and Piketty (2003) argue that high top marginal income tax rates and wealth taxes in the US and France may have helped prevent elites from recovering their Gilded Age fortunes in the aftermath of the shocks created by the Great Depression and WWII. Accordingly, Piketty and Saez (2004: 16) predict that in the US: “the decline in income tax progressivity since the 1980s, the reduction in the tax rate for dividend income in 2003, and the projected repeal of the estate tax by 2011 might produce again in a few decades levels of wealth concentration similar to those of the beginning of the twentieth century.”

Recent theoretical analyses also support the idea that progressive direct taxation is an important redistributive tool in its own right. Applying optimal tax theory in an infinite horizon model, Saez (2002: 3) finds that on the one hand, “capital income taxes can be a very powerful and desirable tool to redistribute accumulated wealth,” and on the other hand, “progressive capital income taxation is much more effective than linear taxation to redistribute wealth.” Saez (2002: 4) notes that these findings are of direct relevance for tax policy:

...the policy prescriptions that are obtained from the model developed here are well in line with the historical record. Introducing a steeply progressive capital income tax does not introduce large efficiency costs and is very effective in reducing the concentration of capital income, as in the historical experience of France and the United States.

Saez (2004b) develops another model that gives rise to similar conclusions regarding the desirability of direct income taxes for redistribution, as well as for raising revenue.

In countries with high and persistent inequality, a strong case can be made for using all available redistributive tools—including taxation—rather than relying on spending alone, even if spending does tend to have the larger direct redistributive impact. This perspective is finding voice in the policy literature. For example, Zee (2004: 360) notes that: “compared to neutral taxation, progressive taxation is better able both to raise the revenue to finance the expenditure *and to support the underlying redistributive objective*” (emphasis added). Similarly, Chu, Davoodi, and Gupta (2000: 37) assert: “Countries that have capacity to increase tax revenue with a degree of progressivity without causing disincentive effects on work efforts would enrich their redistributive policy instruments.” The World Bank (2003: 138) has also acknowledged that making the region’s tax systems at least “somewhat” more progressive is possible and desirable from the point of view of reducing poverty and inequality.

Finally, it should be noted that targeting spending to the poor is not necessarily inherently more difficult than taxing the rich. In many countries, middle and upper-income constituencies receive substantial benefits, for example in the form of state subsidies for higher education, that are politically difficult to eliminate. As Mahon (2009a: 12) observes:

...it was a mistake to assume away political constraints on the spending side when designing tax policy. ... The irony is that neoliberal tax reformers and international advisers invoked a similar realism about political-economic and administrative limitations when they argued for a less redistributive tax code—with the promise that greater revenues would make additional redistribution possible via spending.

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<sup>20</sup>The upward trend was undisturbed by the marginal tax rate increase of 1992. Other causal factors suggested by the author are social norms regarding inequality and the acceptability of very high wages for CEOs (Saez 2004a: 35).

In countries where spending is not effectively targeted to the poor, it may be all the more important to consider taxation as a redistributive tool (Sabaini, author interview 2006).

**Second-Generation Tax Reforms: Tapping Under-Taxed Elite Resources**

Continued revenue needs made tax reform a salient issue throughout Latin America during the 1990s and 2000s, even in countries like Chile and Argentina that had enacted first-generation reforms and subsequently collected substantial revenue from taxes on goods and services. Revenue needs, along with equity concerns, often motivated governments to consider what I term *second-generation tax reforms*<sup>21</sup>—reforms that entail increasing taxation of income, profits, wealth, and/or rents, among other reforms intended to directly tap resources controlled by economic elites.

Second-generation reforms can be categorized according to whether they address *tax policy* or *tax agency powers*. Second-generation tax policy reforms entail altering tax rates or tax bases. Specifically, these reforms include increasing progressive direct tax rates, creating new direct taxes, and eliminating loopholes, exemptions or special benefits that favor upper-income groups. The later can include, for example, eliminating income tax exemptions for types of non-wage income that accrue disproportionately to the wealthy, or broadening the VAT base to include goods or services consumed primarily by the wealthy.

Second-generation reforms also include expanding formal tax agency powers for fighting evasion. Reducing evasion of income taxes or other direct taxes, which tends to be quite high in Latin America, taps elite resources since income and assets are so concentrated. Powers for controlling evasion can be classified according to the tasks they facilitate. *Auditing powers* help the tax agency detect evasion. An important example is tax agency access to bank information, which is critical for fighting income tax evasion. Authority to regulate transfer prices is a *regulatory power* that is important for taxing profits of multinational corporations. Multinationals commonly avoid corporate taxation by contracting services from subsidiaries in other countries at above-market prices in order to lower the apparent value of profits earned in countries that impose relatively high tax burdens. *Enforcement powers* may help the tax agency collect unpaid taxes or indict tax evaders. Examples include authority to seize assets from taxpayers in arrears. Among these various types of powers, I focus primarily on auditing powers.

Of course, not all revenue-raising reforms target elite resources. Revenue-raising reforms that are not second-generation reforms can also be categorized in terms of tax policy and tax agency powers. The former category includes increasing indirect, regressive tax rates, eliminating VAT exemptions on mass consumption items like basic food staples, broadening the income tax base to include lower-income taxpayers or adjusting bracket structures to extract more revenue from middle or lower-income sectors as opposed to elites, and creating new taxes that are not progressive. Tax agency powers that do not directly tap elite resources include those designed to control evasion of indirect taxes rather than direct taxes; for example, relaxing statutes of limitation for auditing VAT records.

**Figure 1.13: Typology of Second-Generation Reforms Targeting Elite Resources**

<b>Tax Policy</b>	<b>Increasing Direct Tax Rates</b>
	<b>Creating New Direct Taxes</b>
	<b>Eliminating Direct Tax Loopholes and Regressive Exemptions or Benefits</b>
<b>Tax Agency Powers</b>	<b>Auditing Powers</b>
	<b>Regulatory Powers</b>
	<b>Enforcement Powers</b>

<sup>21</sup>This language parallels the idea of second-generation reforms in the literature on economic reforms in Latin America.

Other tasks beyond tax policy reforms and expanding tax agency powers may contribute to raising revenue from elites, such as bureaucratic or institutional reforms to improve the tax agency's administrative capacity (Geddes 1994, Taliercio 2004, Eaton 2002, Arce 2005, Fjeldstad and Moore 2008, Bergman 2009), or judicial reforms to expedite trials and convictions of tax evaders. However, these tasks lie outside the scope of this project.

### **Explaining the Tax Reform Agenda and the Fate of Reform Proposals**

This study seeks to explain the observed types, timing, and outcomes of second-generation tax reform proposals, as well as other revenue-raising reforms pursued in the mid-1990s and 2000s. When will policymakers facing revenue needs seek to implement progressive second-generation reforms, as opposed to revenue-raising reforms that do not directly tap elite resources? And when are these reforms likely to succeed? Through what mechanisms can economic elites block attempts to more effectively tap their resources?

Accordingly, I examine two main dependent variables: the tax reform agenda—that is, the set of reforms that authorities in the executive branch consider as feasible options—and the fate of tax reform proposals formally initiated by those authorities. Where reforms were enacted but not implemented, or subsequently overturned within the time-period of analysis, I also analyze the reasons for their postponement or demise.

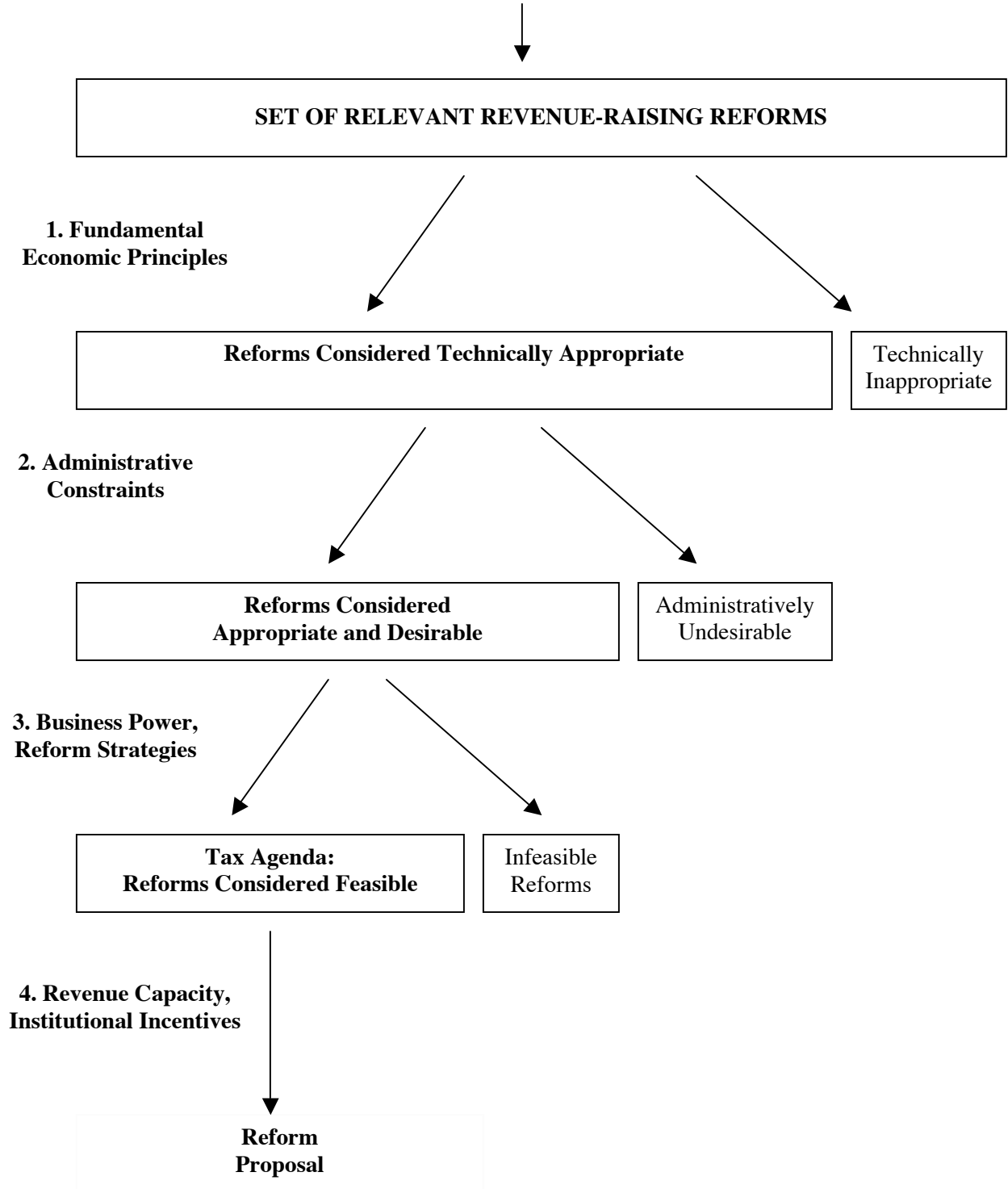
The process through which the reform agenda is defined can be divided into four idealized stages, in which different factors and considerations delineate increasingly restricted subsets of reform options (Figure 1.14). Decision-makers do not necessarily follow these steps sequentially or explicitly; however, these stages serve to identify the main factors that ultimately determine which reforms are considered feasible at a given point in time. The primary emphasis of this research will be the third stage of agenda formulation, in which policymakers assess the feasibility of the reforms they view as appropriate and desirable based on anticipated political and economic reactions. Business power and reform strategies serve as the main independent variables at this stage.

I treat the prevailing tax system and the distribution of different types of assets and income as initial conditions that determine the set of relevant revenue-raising reforms (Figure 1.14). Income tax structures, the mix of direct taxes employed, exemptions, and loopholes vary significantly across Latin America. Similarly, while the distribution of income and assets is highly unequal throughout the region, under-tapped revenue bases are associated with different kinds of investments or income flows in different countries and at different times. Together, the prevailing tax system and the structure of income and assets determine whether or not new taxes can be created to tap under-taxed bases, which exemptions or loopholes account for the greatest loss of potential revenue, which economic sectors are under-taxed, and what powers would most effectively help the tax agency fight evasion. The set of relevant revenue-raising reforms may change over time as some such reforms are successfully implemented and hence removed from consideration. In addition, the nature of under-tapped revenue bases may shift with international economic trends, changes in national development models, or economic crisis. Decision-makers select from this set of relevant revenue-raising reforms, which may include progressive, second-generation tax reforms.

Government decision-makers may rule out revenue-raising reforms that are inconsistent with the fundamental economic principles they espouse (Stage 1). For example, policymakers trained in orthodox economic theory may dismiss progressive reforms that entail increasing individual income tax rates or creating sector-specific taxes. As previously discussed, orthodox economists tend to consider high marginal income tax rates as work disincentives, and they usually view taxes that treat certain sectors differently from others as distortionary and undesirable. Heterodox economists, in contrast, may prioritize other tax policy goals, including industrial policy or equity, over economic efficiency. The subset of reforms defined at this stage—options considered technically appropriate—will thus vary according to the economic training of policymakers in the executive branch.

**Figure 1.14: Defining the Agenda**

**Inherited Tax System (Policy Legacy),  
Distribution and Type of Assets and Income**



Administrative constraints may lead decision-makers to rule out additional revenue-raising reforms (Stage 2). Where the tax agency's administrative capacity is considered weak, policymakers may avoid reforms that increase the number of taxpayers the tax agency must monitor, or that place greater demands on the tax agency in terms of gathering and processing information. The tax agency's administrative capacity can increase or decrease over time, making administrative concerns more or less relevant for ruling out reforms. Together, stages one and two define the subset of reforms considered both appropriate and desirable that executive authorities will be interested in implementing.

Although many revenue-raising reforms may be ruled out during Stages 1 and 2, at any given time, some progressive reforms usually remain on the agenda regardless of decision-makers' economic principles or the tax agency's administrative capacity. Orthodox economists, for example, tend to favor eliminating exemptions and loopholes; these reforms simultaneously enhance efficiency and equity. Both heterodox and orthodox policymakers tend to favor reducing evasion and may therefore consider granting the tax agency additional powers.<sup>22</sup> And where tax administration is weak, reforms can often be designed in ways that place minimal additional demands on the tax agency. For example, taxes on previously exempt forms of income can be collected through withholding regimes, which essentially eliminate opportunities for evasion, rather than relying on taxpayers to include these sources of income on their tax declarations, as discussed previously.

Finally and most importantly for this project, business power, and to a lesser extent reform strategies available to the government, shape the subset of revenue-raising reforms that policymakers view as not only appropriate and desirable, but also feasible (Stage 3). If policymakers anticipate that a reform proposal will elicit a highly problematic response from relevant political and/or economic actors, they may rule it out as an infeasible option. Where business's structural power is strong, policymakers may refrain from initiating certain reforms for fear of provoking reduced investment. Where business's instrumental power is strong, reforms that business opposes may be stricken from the agenda on the basis that they are not worth waging the anticipated political battle and/or the government will likely lose that battle. On the other hand, astutely designed reform strategies may make tax increases more feasible. I subsequently refer to the final subset of reforms defined at this stage as simply the tax agenda, or agenda space. Business power, reform strategies, and the mechanisms through which they affect the scope of the reform agenda, are discussed in detail in Chapter 2.

Institutional incentives and revenue capacity help determine which reforms policymakers chose to initiate from among the options remaining on the agenda (Stage 4). Institutional incentives, created for example by exclusive executive authority in a particular tax policy domain or by rules governing the distribution of tax revenue between the central government and subnational units (Saiegh and Tommasi 1999: 181), may motivate the executive to favor some tax reforms over others. All else equal, policymakers seeking to increase revenue will chose reforms with greater revenue-raising capacity. Where the set of feasible reforms contains more than one option, decision-makers may bundle them together into a single reform proposal.

It is worth noting that business power may also play an indirect role at prior stages of the agenda-formulation process. Business power in previous time-periods may have shaped the prevailing tax system and hence the set of relevant revenue-raising reforms. Business power may influence executive branch appointments and hence the economic ideology espoused by decision-makers and what reforms they view as technically appropriate (Stage 1). And business power may affect administrative capacity and thereby constrain reform choices made during Stage 2. However, explaining the origin of tax systems and levels of administrative capacity prior to the time-period under consideration lies outside the scope of this project. Likewise, I do not seek to explain how or why decision-makers came to espouse a certain set of

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<sup>22</sup>Hart's (2009: 19) assertion that "Increasing the rate of tax collection, cutting the cost of tax collection, and stymieing tax evasion are all distinctly rightist goals in South America's neoliberal era" simply does not hold up under examination of case evidence. On the left's advocacy of anti-evasion reforms and the right's resistance in Chile, see Chapter 4. On the cross-partisan consensus in favor of anti-evasion measures in Argentina, see Chapter 5. On President Chavez's anti-evasion agenda in Venezuela, see Ellner (2008: 125).

technical views and economic principles, although I do address business influence over executive branch appointments when it is relevant in my cases.

The fate of reform proposals initiated by decision-makers is determined by the same independent variables that affect the scope of the tax agenda—business power and reform strategies. The mechanisms through which these factors influence whether a reform proposal is legislated in the form originally proposed, modified, or blocked entirely, are also elaborated in Chapter 2.

### **Research Design, Methods, and Data**

This project employs qualitative comparative research techniques to systematically analyze the tax reform agenda and tax reform proposals across countries and over time. Moreover, I compare outcomes in a wide range of distinct tax policy areas. This design allows me to identify and explain theoretically significant variation in political dynamics and outcomes across tax policy areas, which previous studies that examined aggregate levels of taxation or composite indices of tax reform (Mahon 2004, Wibbels and Arce 2003) were not able to detect. In the following sections, I discuss my case selection procedures, the methods I employ for assessing causality, and the multiple sources of data that inform my analysis.

### **Case Selection**

Case selection proceeded in two stages. I first selected “most-likely cases” for second-generation tax reforms—countries in which policymakers could be expected to consider raising additional revenue from taxes that target elites, rather than taxes with broader incidence. I later identified relevant reform proposals initiated, as well as proposals policymakers considered but discarded, during comparable time periods in each country. This strategy proved necessary given the dearth of secondary literature on taxation in Latin American and the difficulty of obtaining information from the US about policymakers’ tax reform agendas and relevant reform proposals. Interviews with government policymakers are essential for delineating the scope of the reform agenda. And while legislative records of reform proposals are available online in some cases, identifying relevant proposals without consulting in-country tax experts is not feasible in practice because of the diversity and complexity of Latin American tax systems. Accordingly, selection of proposal cases took place to a large extent during the early stages of field research. I discuss selection of countries and initiated proposals below in turn.

### **Countries**

Chile and Argentina are the primary countries examined in this study; Bolivia serves as a secondary case. I selected these countries by first identifying two types of most-likely cases for second generation reform and then narrowing down the resulting options according to additional theoretical criteria.

The first type of most-likely case includes countries where policymakers would have incentives to target elite resources based first and foremost on revenue-raising considerations. Under-taxed income and profits are likely to be more attractive for raising revenue where VAT bases are already broad, VAT rates are high, and consumption tax bases more generally are heavily tapped. I define this set of most-likely cases as “leading first-generation tax reformers:” countries with scores above Morley et. al.’s (1999) suggested threshold of 0.6 on their index of tax reform by the year 1994, and revenue from consumption taxes in the mid 1990s exceeding the regression line prediction based on GDP per capita at purchasing power parity. Morley et al.’s (1999: 17) index ranges from 0 to 1, with higher scores corresponding to lower maximum tax rates on corporate and personal income, higher VAT rates, and higher ratios of VAT collections to VAT rates (a measure of the breadth of the VAT base),<sup>23</sup> in accord with the principles advocated by international advisors during structural adjustment. As displayed in Figure 1.15, Chile, Argentina, Bolivia, and Brazil satisfy both criteria.<sup>24</sup> Uruguay also qualifies; however,

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<sup>23</sup>This ratio also reflects administrative capacity and/or evasion levels.

<sup>24</sup>Paraguay surpassed Morley et al.’s tax reform cutoff by 1994, but its revenue from goods and services fell by 2.6 percentage points of GDP below the GDP per capital regression prediction. Peru achieved the average tax reform score among the countries analyzed (0.58), but indirect tax collections also fell significantly below the GDP per capita prediction—by 1.2% of GDP.

I exclude this country because it historically had much lower income inequality than the rest of the countries in the region, and my goal is to examine the political challenge of raising revenue from economic elites in contexts of high inequality.<sup>25</sup>

**Figure 1.15: Leading First-Generation Tax Reformers\***

	<b>Bolivia</b>	<b>Brazil</b>	<b>Chile</b>	<b>Argentina</b>	<b>Latin American Average</b>
<b>First-Generation Tax Reform Index, 1994†</b> Threshold: 0.6	0.79	0.71	0.66	0.60	0.58
<b>Consumption Tax Revenue Exceeding GDP/capita PPP Prediction††</b> Average 1995-1999	+0.3	+0.2	+1.7	+0.9	-1.9

\*Excluding countries with historically more equitable income distributions (Uruguay and Costa Rica).

†Morley, Machado and Pettinato 1999: 29. Latin American average includes 15 countries.

††Using Mahon's (2009b, personal communication) regression of indirect tax revenue from World Bank and IMF data in 99 countries with respect to GDP per capita at purchasing power parity. I compare the regression line to tax collection data from the following sources: Bolivia: SIN, Chile: SII, Argentina: DNIAF, Brazil and other Latin American countries (17 total): Sabaini 2005. These data differ in some cases from World Bank data.

The second type of most-likely case includes countries where policymakers could be expected to pursue second-generation tax reforms based on equity considerations, rather than revenue-raising considerations alone. These most-likely cases are countries where left-leaning presidents held office and/or heterodox economists were appointed to top policymaking positions at some point after the early 1990s. Two countries that do not belong to the set of leading first-generation tax reformers elected presidents prior to 2006 who might have sought to tax elites for ideological reasons: Ecuador (Gutierrez, 2003-2005) and Venezuela (Chavez, 1999-present). However, neither Gutierrez nor Chavez proposed significant tax reforms. Although Gutierrez campaigned on a leftist platform, he quickly switched to a more conservative economic agenda once in office and appointed an orthodox economist as his finance minister (Campello 2009: 23). Chavez, meanwhile, benefited from increasing oil rents after 2003 (García and Salvato 2006: 363-4) and in fact proposed tax cuts in 2007.<sup>26</sup>

Among the leading first-generation reformers, Chile and Argentina form a fruitful pair for comparison. These countries share similar levels of economic development and similar tax structures in terms of the level of government primarily responsible for collection. Both Chile and Argentina have similar levels of economic development. Real GDP per capita at purchasing power parity averaged USD 10,300 in Chile and USD 10,800 in Argentina from 1995 to 1999—among the three highest in Latin America (Penn World Tables). By comparison, average per capita GDP at purchasing power parity in Brazil was only USD 6,700 and significantly lower in Bolivia: USD 2700. In addition, the central government, which is the focus of my research, collects the great majority of total tax revenue in both

<sup>25</sup>Argentina also had historically lower levels of inequality than other countries in the region, but inequality increased dramatically in the 1990s. In 1999, 43% of national income in Argentina accrued to the top 10%, while in Uruguay, the top 10% received only 34% of national income (CEPAL 2007).

<sup>26</sup>Chavez did pass anti-evasion legislation that allowed the tax agency to substantially improve collections in 2004 (Ellner 2008: 125). These reforms merit attention in future research. Likewise, policymakers in countries that do not fall within either of the most-likely case categories defined above did on occasion propose tax reforms that targeted economic elites. Examples include Costa Rica (2002), Guatemala (1987, 2001), and more recently, Mexico (2005), where reform packages included direct tax increases along with more traditional first-generation reform measures. Proposed reforms in these countries also merit consideration in future research.



Chile and Argentina, despite the fact that Chile is a unitary state whereas Argentina is a federation. Chile's central government collects about 96% of tax revenue, while Argentina's central government collects 85% of all tax revenue (Cetrángolo 2007: 33). In contrast, Brazil's central government collects only 70% of total tax revenue (Cetrángolo 2007: 32, 33); a major value-added tax, which is "the most important source of tax revenue" according to Lledo, Schneider, and Moore (2004: 31), is collected by the states.

Chile and Argentina also encompass variation in country-level factors relevant to business power, as well as policymakers' economic orientations, which help shape the reform agenda. As discussed in the following chapter, business's instrumental power tends to be stronger where business is highly organized and where there are electorally-significant parties of the right. Both of these factors are present in Chile but not in Argentina. In addition, patterns of government business relationships differ across the countries. Institutionalized business-government consultation is a source of instrumental power in Chile that is also absent in Argentina. Turning to economic principles espoused by executive branch authorities, there is variation both across and within these countries. Argentina provides a range spanning from orthodox neoliberals under Menem (1989-1990) to heterodox economists under Kirchner (2003-07). In Chile, pragmatic neoliberals demonstrated greater interest in tax equity under Lagos (2000-05) and lesser interest in tax equity under Bachelet (2006-2009).

In addition, a Chile-Argentina comparison holds constant several institutional factors that may affect the fate of government reform proposals in congress. First, fiscal policymaking authority is concentrated within a single ministry in both countries, in contrast to Brazil, where fragmentation of authority and rivalries among different state agencies hindered reform initiatives proposed by the executive (Weyland 1996: 5, 17-18, 31, Weyland 1997: 59).<sup>27</sup> Second, executives in each country have strong formal legislative powers. In Chile, the executive enjoys exclusive initiative on tax policy. Legislators cannot initiate tax bills, nor can they amend the executive's tax proposals; they can only approve or reject the articles included. The executive also enjoys other agenda-setting powers including the ability to force Congress to debate a proposal within a set period of time. In Argentina, the executive enjoys broad decree and veto powers, including the right to exercise line-item veto. In fact, the Argentine and Chilean executives are among the strongest in Latin America in terms of formal policymaking powers (Mainwaring and Shugart 1997: 49, 432, 442, Eaton 2002: 22).

Third, Chile and Argentina have comparatively stable party systems consisting of two major blocks (*Concertación de Partidos por la Democracia* vs. *Alianza por la Democracia* in Chile; Peronists vs. Radicals in Argentina) with high levels of party discipline (Mainwaring and Scully 1995, Carey 2002, Jones 2002, Eaton 2002, Weyland 2002: 11).<sup>28</sup> While the Radical party has fragmented in recent years, Argentina has avoided the party system collapse characteristic of other Latin American party systems with labor-mobilizing parties (Venezuela and Peru). Where party systems are volatile, highly fragmented, and/or party discipline is low, as in Brazil or in Peru after party system collapse, the presence of multiple veto players and the likelihood of weak support for the executive in congress may make government reform proposals difficult to pass regardless of their content (Carey and Shugart 1998: 17, Mainwaring 1999, Chapter 10, Mainwaring and Shugart 1997, Weyland 2002: 230). For example, Lledo, Schneider and Moore (2004: 45) observe that tax reforms in Brazil in the 1990s "faced stumbling blocks at multiple veto points, including subnational governments and also opposition parties, fragmented legislatures, and slowly moving judiciaries."

Most importantly, policymakers in both Chile and Argentina did in fact seek to raise additional revenue, and the initiatives proposed included second-generation reforms. In Chile, center-left governments sought to raise additional revenue for social spending and redistribution while maintaining fiscal discipline. Although Chile has significantly reduced its poverty rate, beneficiaries of targeted

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<sup>27</sup>Lledo et al (2004: 60) note, however, that Brazil's Law of Fiscal Responsibility, passed in 2000, increased the power of the Finance Ministry relative to other actors and created more hierarchical budget institutions.

<sup>28</sup>In Chile, the *Concertación* shows higher levels of within-coalition discipline than the *Alianza* (Carey 2002); however, my research shows that the *Alianza* tends to be united on the issue of taxation.

spending programs remain in economically precarious situations, inequality is still extremely high, and limited tax revenue has constrained expansion of social spending. Second-generation reform proposals included eliminating income tax and VAT benefits that favored upper-income individuals. In Argentina, governments sought additional revenue in the 1990s to maintain fiscal balance and sustain Convertibility, which pegged the peso to the dollar and tied monetary expansion to growth in reserves. After the 2001 crisis, governments sought revenue to reestablish fiscal solvency and to finance social spending programs designed to redress the dramatic increase in poverty (Garay 2007).<sup>29</sup> Second generation reforms included increasing corporate taxation and expanding tax agency access to bank information.

The final empirical chapter includes a preliminary discussion of a third country belonging to the set of leading first generation reformers—Bolivia—where policymakers attempted to raise revenue by directly tapping elite resources in the early 2000s. I thereby extend my analysis to a country with a lower level of economic development and a very different party system. Bolivia’s historically patronage-based party system (Gamarra and Malloy 1995) experienced dramatic change due to the emergence of an electorally successful indigenous-left party and the partial demise of the more conservative traditional parties. Consideration of Bolivia allows me to incorporate additional variation in the sources and strength of business power, and to examine tax politics in a context where non-business actors—namely, organized and highly mobilized popular sectors—played a far more substantial role in influencing the tax agenda and proposal outcomes than in Chile and Argentina.

### **Reform Proposals**

I examine reform proposals involving tax policy or tax agency powers initiated in Argentina from 1992 through 2008, in Chile from 1990 through 2008, and in Bolivia from 2003 through 2006. The starting point of these time-periods corresponds to the completion of first-generation reforms and/or the emergence of second-generation reforms on the national agenda. In Argentina, core first-generation tax reforms, including VAT base-broadening, were enacted in 1990 and 1991, and currency stabilization, a key objective of structural reforms, was achieved in 1992. In Chile, first-generation tax reforms were carried out under the Pinochet dictatorship, and subsequent initiatives to increase tax revenue did not occur until after the 1990 democratic transition. In Bolivia, first generation tax reforms were enacted via a major overhaul of the tax system in 1986. Second-generation reforms were not considered thereafter until 2003; after 2006, other issues superceded tax reform on the national agenda. The time-periods examined span five major presidential administrations in Argentina, four in Chile, and three in Bolivia. This breadth allows me to identify changes in business power over the long-term as well as the short-term and to assess the impact on the tax agenda and the fate of reform proposals.

My case universe consists of all major revenue-raising reform proposals, as well as proposals with more minor revenue capacity that targeted elite resources, initiated in each country during the period of interest. By examining revenue-raising proposals that did not target elites resources as well as those that did, I gain more leverage for explaining the scope of the tax agenda and policymakers’ choices, the nature and extent of business influence, and the success or failure of reform initiatives that did in fact target elites. In some cases, the proposal of primary interest is bundled with other measures in a broader tax reform package. In these cases I treat the reform package as a contextual factor with implications for government reform strategies and the fate of the measure or measures of interest.

I identified all relevant reform proposals based on an iterative process that involved reviewing legislative records and news coverage, and, most importantly, consulting with tax experts, policymakers, and business advisors in each country. I focused on proposals from the resultant lists that were most consistently identified by experts as major revenue-raising and/or elite targeted initiatives. These cases included both successful and unsuccessful initiatives, as well as proposals that became law only after significant modifications. In Argentina, I collected data on 36 discreet proposals embedded in 22 reform

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<sup>29</sup>Governments in both countries also sought to raise revenue in order to compensate reductions of taxes judged to be distortionary or otherwise undesirable (for example, tariffs in Chile, employers’ social security contributions and transaction taxes in Argentina).

packages. In Chile, I gathered data on 34 discreet proposals embedded in 17 reform packages. And in Bolivia, I obtained data on 12 proposals embedded in 9 reform packages.

While my broader arguments are informed by and incorporate examples from the full set of 82 proposals, the empirical chapters that follow emphasize proposals from the late 1990s on for practical reasons. Informants often had difficulty recalling the details of reform initiatives from the early 1990s, and written records alone did not always provide sufficient information to reconstruct policy processes.<sup>30</sup> The empirical chapters include detailed case studies of 17 proposals (13 reform packages) in Argentina, 19 proposals (12 reform packages) in Chile, and 4 proposals (3 reform packages) in Bolivia. When political dynamics and outcomes did not vary across a set of proposals bundled into a single reform package, I treat that aggregate set of proposals as the unit of analysis.

In addition to initiated proposals, I analyze cases in which policymakers considered but decided against proposing tax reforms they felt were important. I identified these cases through interviews with current and former high-level executive branch policymakers.

### **Methods for Causal Inference**

Multilevel comparisons, process-tracing, and counterfactual analysis, each of which has a long and respected tradition in qualitative research, are the primary methods I use to draw causal inferences regarding the scope of the tax agenda and the fate of reform proposals.

My research design employs multiple levels of structured, focused comparisons (George and Bennett 2005: Chapter 3), within and across countries, tax policy areas, and economic sectors, to gain analytic leverage. One level entails comparisons of divergent outcomes in the same or analytically comparable policy areas across countries. A second level involves comparisons of reform proposals within a single country. I compare successive reform attempts designed to address persistent tax issues over time in order to identify factors that contributed to eventual success or repeated failure. In Argentina, my comparisons follow a sectoral logic, in accord with the nature of variation in business power in that country. I compare reform proposals in different tax policy areas affecting a single sector and also contrast tax politics across sectors. These multiple comparisons help to highlight the role played by different causal factors while holding others relatively constant.

In addition to structured comparisons of tax proposals, I make ample use of within case analysis based on “causal-process observations” (Collier, Brady, and Seawright 2004: 252-259), also known as process-tracing (George 1979, George and McKeown 1985: 34-41, Mahoney 2000, George and Bennett 2004, Bennett 2008). Whereas systematic cross-case observations underpin correlation-based causal inference, causal process observations can provide inferential leverage independently of their relationship to a larger cross-case dataset by providing information about “context or mechanism” (Collier, Brady and Seawright 2004: 253). Accordingly, process-tracing allows the researcher “to identify and analyze the temporal sequence through which hypothesized explanatory variables affect outcomes,” (Munck 2004: 111). In contrast to large-N statistical analysis, process-tracing is ideal for identifying causal mechanisms, a major goal of this project. My causal-process observations draw on rich data gathered over the course of extensive, in depth fieldwork.

Process-tracing, as well as emphasis on observable sources of power, allow me to effectively employ the business power framework for causal analysis. Analysts occasionally draw conclusions about an actor’s power based on the degree of congruence between policy outcomes and that actor’s preferences. Given that I examine business power to explain policy outcomes, assessing business power based on those outcomes would be tautological. However, the sources of business power described in Chapter 2 can be identified independently of policy outcomes, and process-tracing elucidates the

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<sup>30</sup>These problems were more salient in Argentina compared to Chile. In addition, fewer policymakers involved in tax reforms of the early 1990s were available for interviews in Argentina than in Chile. Partly because of these data limitations, I do not examine a handful of tax proposals targeting elite resources that were initiated in Argentina during Menem’s first administration, while first-generation tax reforms were underway.

mechanisms and sequence of events through which business managed, or failed, to use its sources of power to influence policy in different cases.

I supplement the above methods with counterfactual analysis (Fearon 1991, McKeown 2004: 141, Brady 2008) to analyze the scope of the tax agenda. Counterfactual analysis based on data from interviews allows me to identify factors that dissuaded policymakers from proposing reforms they viewed as desirable. In addition, I employ counterfactual analysis to adjudicate between alternative arguments in cases where rival hypotheses are consistent with observed outcomes. Together, multilevel comparisons, process-tracing, and counterfactual analysis provide strong analytical leverage for causal inference.

### ***Data Sources***

Over the course of 18 months of intensive field research supported by the Social Science Research Council and Fulbright-Hays, I collected extensive data from interviews, primary documents, and newspapers. This data allowed me to reconstruct policymakers' decision-making processes and the sequence of events surrounding reform proposals that influenced their fate.

In-depth, semi-structured elite interviews serve as a primary data source. I conducted 381 interviews with 322 informants in Chile, Argentina, and Bolivia. The bulk of the interviews were conducted from 2005 to 2007; additional interviews were conducted during follow-up visits to Chile and Argentina in 2008. I was able to obtain multiple interviews over extended time-periods with many key informants, which allowed me to update information, cross-check facts, and explore new ideas developed over the course of my fieldwork. My interviews included two former presidents (Ricardo Lagos of Chile and Carlos Mesa of Bolivia) and almost every finance minister who served in each country during the time-period examined (eleven former and one subsequently appointed finance minister). Interviews with these and other high-level government policymakers provided invaluable information about decision-making processes and negotiations with business and other political actors that shaped tax reform outcomes. Finance ministers and their technical staff proved especially useful informants, given that they were usually in charge of articulating the tax agenda, designing tax reform proposals, interacting with the organized interests affected, and maneuvering legislation through congress. In my experience, these informants generally served as open and reliable sources of information. Although many technocrats had strong political affiliations, they had few incentives to distort facts to a foreign academic. These informants frequently shared information that they might not have provided to the national press or local researchers. Of course informants may remember events incorrectly or incompletely; consulting with multiple informants as well as crosschecking facts with written records allowed me to detect and resolve inconsistencies.

In addition to finance ministers and other high-level government officials, I interviewed tax agency directors and staff, politicians from all major political parties, business leaders and advisors, economists, and other actors who participated in policymaking processes. Tax agency officials provided information about the tax agency's powers and additional powers needed to control tax evasion, and they served as sources of expert knowledge about tax laws, tax incidence, and the history of tax reforms. Moreover, tax agency officials were often important actors in designing anti-evasions reforms and occasionally participated in political negotiations with legislators and other actors. Legislators and party leaders provided valuable information about constraints executives faced in congress and the nature of the political conflicts reform initiatives created. Interviews with business informants provided information about business positions regarding reform proposals, lobbying initiatives, and the presence or absence of salient divisions within the private sector. Economists in academics and in the private sector served as an additional source of expertise on tax legislation and tax incidence. I identified relevant informants through chain referrals as well as revision of congressional records and news coverage of reform proposals.

In addition to interviews, I examined primary documents including summaries of congressional committee meetings, transcripts of debates on the floor of congress, analyses of tax proposals prepared by business associations, official publications issued by the finance ministry and other agencies, and in some cases (Chile), tax agency and government reports elaborated for purely internal review. While some of

these sources are available on-line, many of the documents I consulted, including a substantial number of congressional records,<sup>31</sup> could be obtained only through in-person requests. Access to internal government reports was facilitated by rapport with authorities generated over the course of multiple interviews.

Newspaper articles served as a useful source of factual information about the political process surrounding reform proposals and the public positions taken by different actors at the time. This information can be particularly important in cases where actors' contemporary positions differ from those held while policy decisions were being made. As Hacker and Pierson (2002: 285) emphasize, citing Vogel (1978), accurately assessing business influence requires knowledge of business's initial positions. Given that coverage of tax reforms varied in extent and detail, I consulted multiple newspapers in each country. I conducted searches of on-line article databases for coverage of recent reforms. For earlier reforms, I systematically reviewed print copies in public archives (national and congressional libraries), and in two cases, private archives (*Clarín* in Buenos Aires, Argentina, and *El Deber* in Santa Cruz, Bolivia). In Chile, I also made use of an archive of topically categorized clippings maintained by the Pontificia Universidad Católica.

Finally, various aspects of my analysis including assessment of tax incidence and potential disinvestment threats draw on statistics compiled by tax agencies, central banks, and other government agencies and independent organizations.

### Overview

The chapters that follow develop and apply my analytical framework to explain outcomes across tax policy areas and over time in Chile and Argentina. Chapter 2 discusses business power, government reform strategies, and alternative explanations. I first identify observable sources of business power. Sources of instrumental power, which entails deliberate political action to influence policy, can be classified under two categories: *relationships* with decision-makers that can create a bias in favor of business interests, and *resources* that allow business to pressure policymakers more effectively. Structural power, which requires no political action, arises from a market-coordinated *disinvestment threat*—a perceived threat that reform would lead to a significant reduction in investment in an important sector of the economy or more broadly, or other undesirable macroeconomic outcomes, due to the market signals it creates. In order for policymakers to perceive a disinvestment threat as credible, they must believe that a reform will create real incentives for individuals or firms to withhold or relocate investment. Sources of instrumental power and structural power can vary across countries, over time, across sectors, and across policy areas. Instrumental power or structural power alone may be sufficient to block reform, or to keep reform off policymakers' agenda altogether. Where both instrumental power and structural power are present, they may interact in mutually reinforcing ways.

I proceed by developing a typology of strategies that governments have used to circumvent business power and build support for reforms that require approval in congress. I classify strategies into two main categories. *Tax-side strategies* exploit characteristics of the selected tax increase itself, while *benefit-side strategies* aim to shift attention away from the tax increase by forging links to benefits associated with the tax reform. The strategies I identify may reduce business opposition to reform, they may counter-balance business pressure on politicians by mobilizing public support for reform, and/or they may reduce concern regarding the impact of reform on investment. Strategies are often closely associated with tax policy choice or the design of a broader reform package.

The empirical chapters that follow illustrate that business power, and instrumental power in particular, explain most of the variation in tax outcomes across countries. Where business power was strong, government reform strategies generally facilitated tax increases only at the margins, whereas

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<sup>31</sup>Records of committee meetings prior to the mid-2000s in Argentina exist only in hardcopy and cannot be removed from the office in which they are housed in congress. In Chile, online archives of congressional debates are incomplete for the early 1990s. In Argentina, online archives of congressional debates date back to only 1998.

governments had much greater leeway to increase taxes when business power was weak. However, strategic errors on the part of the government occasionally contributed to the defeat of tax proposals in contexts of comparatively weak business power.

Chapters 3 and 4 examine tax reform in Chile, where strong instrumental power precluded all but marginal tax increases from 1991-2008. Chapter 3 analyzes the politics of increasing corporate taxation, which is critical for raising revenue from economic elites in Chile due to special characteristics of the country's income tax system. Chapter 4 analyzes alternative revenue-raising and equity-enhancing reforms that governments initiated in other tax policy areas.

Chapter 3 argues that three sources of instrumental power—linkages to right-wing opposition parties (partisan linkages), business cohesion, and informally institutionalized government-business consultation—allowed business to keep significant corporate tax increases off of the government's agenda, despite weak structural power. Partisan linkages gave business the ability to block reforms in congress, and cohesion allowed business to effectively mobilize against tax increases. Meanwhile, government-business consultation on all aspects of economic policy created incentives for the government to avoid conflict with business on taxation. I argue that strong instrumental power has constrained corporate tax policy ever since the transition to democracy, although lack of reform under the Bachelet administration (2006-2009) can also be attributed in part to large fiscal surpluses created by high international copper prices and different policy preferences held by the government's economic team.

Although strong instrumental power kept corporate tax increases off of the agenda in Chile, the center-left coalition that occupied the executive branch since 1990 developed a broad repertoire of strategies to facilitate incremental revenue-raising reforms in other tax policy areas. Chapter 4 examines the tax reform agenda and explains the fate of proposals initiated in five policy areas: anti-evasion initiatives, consumption tax increases, extractive resource taxation, elimination of a regressive income tax benefit, and restriction of a regressive VAT exemption. The analysis of each policy area demonstrates the key role played by business's instrumental power in restricting the reform agenda, although concerns over structural power and other constraints occasionally contributed to that outcome as well. The proposal case studies elucidate the potential and the limitations of tax-side and benefit-side reform strategies. Overall, while these strategies were critical for increasing taxation, the political space they created for reform proved quite narrow, given business's strong instrumental power.

The next two chapters turn to tax policy in Argentina. Business power at the aggregate level was much weaker than in Chile but varied significantly at the sectoral level; tax reform outcomes varied accordingly. Chapter 5 examines corporate tax reform, a cross-sectoral policy issue, while Chapter 6 analyzes reforms in sector-specific policy areas.

In Argentina, as in Chile, structural power for the most part did not create significant constraints on corporate taxation; in this context, Chapter 5 argues that business's much weaker instrumental power gave policymakers greater leeway to increase corporate taxes than in Chile. Business cohesion in Argentina was quite weak; sectoral divisions and organizational fragmentation made it difficult for business to engage in collective action against cross-sectoral tax increases. Business lacked allies in congress, given the absence of a traditional right party in Argentina. Meanwhile, relationships with executive branch policymakers created instrumental power at the sectoral level or lower. Given very weak business cohesion, those sectors that did enjoy favorable relationships with the executive—thanks to appointment of business leaders to ministerial positions, for example—pursued their own particular interests rather than defending the interests of business as a whole. Thanks to business's weak instrumental power, governments were able to significantly increase corporate taxation from 1992 to 2006, whereas corporate tax revenue stagnated in Chile.

Although business power at the cross-sectoral level was much weaker than in Chile, certain sectors in Argentina enjoyed strong instrumental and/or structural power during delimited time-periods that allowed them to block or reverse tax increases with sector-specific impact. In fact, business power varied significantly not only across sectors, but also across time and across tax reform proposals in Argentina, in contrast to the remarkable uniformity and stability that prevailed in Chile. Chapter 6 examines tax reforms affecting two major economic sectors—agriculture and finance—and explains when and why

reform proposals succeeded or failed by analyzing changes in business power. The case studies I examine illustrate the mechanisms through which turnover in the executive branch, economic crisis, change in economic development model, and international pressures can alter business power, facilitating reforms that had been impossible during a prior period or preventing tax increases in policy areas that had previously been free from effective opposition.

Chapter 7 examines tax policy in Bolivia. From 2002 to 2005, business enjoyed instrumental power of intermediate strength compared to Chile and Argentina, and tax outcomes varied across policy areas. Partisan linkages and cohesion, which were weaker than in Chile but stronger than in Argentina, helped business defeat a wealth tax proposed in 2003. However, business power was challenged by popular sector countermobilization on tax issues and an imminent, radical threat from below to the social, economic and political status quo, a factor not present in the other country cases. Popular mobilization counterbalanced business power in two ways. First, the threat of massive demonstrations compelled governments to eliminate alternative reforms that did not patently target economic elites from the set of feasible revenue-raising options. Second, popular mobilization to demand higher taxation of a specific group of economic elites, namely, multinational companies in the hydrocarbons sector, forced reform onto the agenda and overwhelmed business power. Popular mobilization, along with business's weaker instrumental power, explain why much larger tax increases on natural resource extraction were legislated in Bolivia than in Chile.

The concluding chapter discusses insights into tax reform politics and business politics more generally. Different tax policy areas give rise to different politics, and political dynamics at the national level remain central to tax policy, despite globalization. Business's instrumental power can be as important as structural power for setting the policy agenda, and capital mobility alone does not afford business influence over policy. My research questions recent arguments that elite cohesion facilitates progressive reform; cohesion is a source of instrumental power that can help business block redistribution. Likewise, while strong business associations and government-business consultation may make positive contributions to macroeconomic outcomes and governance, in highly unequal societies, these factors may hinder redistributive reforms that are critical for other aspects of the "public good," including social peace and the quality of democracy.

## **Chapter 2. Business Power, Government Reform Strategies, And Alternative Explanations**

Business, whether organized as associations or in the form of individual firms and investors, is a central actor in tax politics. Many taxes directly affect profits, a core business interest. Business is often an important actor even when the taxes in question do not directly affect corporate profits. Business owners pay personal income taxes as individuals, and business associations may in practice defend their members' class interests rather than concerning themselves strictly with issues that affect corporations as institutions. Further, a wide range of taxes may indirectly affect prospects for growth and profitability. For example, increasing sales taxes or individual income taxes may reduce demand for goods and services produced by the private sector. Consequently, business associations and/or business leaders frequently oppose tax increases.

To understand the ways in which business exerts influence, political scientists writing in the 1960's through the early 1980's conceptualized two types of power: instrumental power, which entails active engagement in political processes, and structural power, which arises from individual investors' market behavior. Distinguishing between these two types of power is critical for identifying the means and mechanisms of business influence and strategies for building tax capacity.

This chapter begins by discussing instrumental power and structural power and the ways in which these two types of power can interact or reinforce one another. Instrumental and structural power will serve as the primary independent variables for explaining the scope of the tax agenda and the fate of reform proposals in the following empirical chapters. I then present a typology of government reform strategies for circumventing business power. When either instrumental or structural power is strong, taxing elites will be difficult, but the reform strategies I identify can facilitate tax increases, at least at the margins. The chapter ends with a discussion of alternative arguments for explaining variation in tax policy outcomes, some of which draw on ideas related to business power and some of which emphasize other explanatory factors.

### **Instrumental Power**

Instrumental power, as first theorized by authors such as Mills (1956) and Miliband (1969), involves deliberate political actions to influence policy in the political arena. Fuchs (2007: 56) reviews the main features of power discussed in this literature: "Instrumentalist approaches to power employ an actor-centered, relational concept of power based on the idea of ...voluntary action..." Although the term instrumental power is not as commonly used today, activities it encompasses, particularly lobbying and campaign finance, remain major topics in research on business and politics.

Instrumental power can operate through different actions initiated in different arenas (Figure 2.1). Lobbying in formal policymaking arenas—the executive branch or the legislature—can influence policymakers' decisions. In some cases, business may even participate directly in policymaking. Financing campaigns can influence who become policymakers in the executive and/or legislative branches, which in turn shapes policy outputs. Moving beyond formal policymaking arenas, business may editorialize in the media, with the aim of influencing policy decisions. And on rare occasions, business may undertake protest, either in the societal arena or in the economic arena. Societal protest may take the form of demonstrations or other disruptive actions that require force in numbers. Economic protest takes the form of capital strikes, which I define as deliberate, politically-coordinated decisions to disrupt the normal economic activities in which businesses and entrepreneurs engage, like investment, production, or commercialization of goods.<sup>1</sup> Business protest may aim to either influence policy decisions, or to influence who become policymakers, for example, by effecting a change of government.

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<sup>1</sup>The distinction between capital strikes and structural power is examined later in the chapter.



**Figure 2.1: Instrumental Power: Arenas and Actions**

Arena		Actions
Within Formal Policymaking Arenas	Executive Branch and/or Legislature	Lobbying, Participating in Policymaking, Financing Campaigns
Outside Formal Policymaking Arenas	Media	Editorializing
	Societal and/or Economic Arena	Protest

Building on the classic literature and later works, I identify and classify specific, observable *sources* of instrumental power. These sources of power fall under two categories: formal or informal *relationships* between business and decision-makers, and *resources* (Figure 2.2). Relationships include *informal ties* to decision-makers, *recruitment* into government (appointing businesspeople to cabinet positions) or into political parties, *partisan linkages* (where business is a party’s core constituency), and *institutionalized consultation* between government and business. These relationships afford business instrumental power in formal decision-making arenas by providing access to policymakers and/or creating a bias in favor of business interests. Depending on the nature of business’s relationships, instrumental power may be weak in the legislature but strong in the executive branch, or vice versa. Resources include *cohesion* (capacity for collective action), *technical expertise*, *media access*, and *money and financial contributions*. These resources allow business to lobby or pursue its interests through any of the actions described above more effectively. The subsections that follow examine these sources of instrumental power and the mechanisms through which they grant business influence in greater detail.

**Figure 2.2: Sources of Instrumental Power**

<b>RELATIONSHIPS with DECISION-MAKERS</b>	<b>Recruitment</b>
	<b>Informal Ties</b>
	<b>Institutionalized Consultation</b>
	<b>Partisan Linkages</b>
<b>RESOURCES</b>	<b>Cohesion</b>
	<b>Technical Expertise</b>
	<b>Media Access</b>
	<b>Money and Financial Contributions</b>

While many other authors have discussed one or more of the sources of power I identify, contemporary literature rarely treats them in a systematic and conceptually coherent way. Schneider (2009) presents the best alternative framework; he identifies “channels of influence,” some of which correspond to sources of instrumental power listed above—for example, networks (e.g. informal ties) to governing elites and appointment to government positions (e.g. recruitment into government), and some

of which correspond to activities—lobbying in congress and campaign finance.<sup>2</sup> However, Schneider’s framework is designed with the goal of characterizing patterns of business participation in politics, rather than examining how and when business achieves influence over policy. In contrast, my categorization of sources of instrumental power on the one hand, and business actions on the other hand, is designed to elucidate more clearly the means and mechanisms through which business achieves influence.<sup>3</sup>

Sources of instrumental power can vary substantially, not only across countries, but also across sectors and over time within a given country. Business may have instrumental power at the cross-sectoral and/or sectoral levels. Strong instrumental power at the cross-sectoral level can block reforms that affect shared business interests. Cross-sectoral instrumental power may even block sector-specific reforms. Alternatively, a sector may have sources of instrumental power that allow it to influence reforms affecting its own sectoral interests, even if business’s cross-sectoral instrumental power is weak. Some sources of power, like government-business consultation in Chile, arise as a result of national historical processes and tend to be relatively stable over periods of several decades or more, while others, like recruitment into government or informal ties to policymakers, can vary over time-periods as short as an electoral cycle. Accordingly, the venues in which business enjoys instrumental power may shift over time as well. Institutionalized relationships with policymakers (partisan linkages and institutionalized consultation) tend to be more stable sources of power over time than non-institutionalized relationships (recruitment into government and informal ties).

Instrumental power does not operate in a deterministic manner. Business will not necessarily be able to influence policy in any particular case even if it enjoys one or more sources of instrumental power. Given that instrumental power involves interactions and extended relationships with decision-makers, there is always a potential that influence can flow both ways, not only from business to decision-makers, but from decision-makers to business. Consequently, as Fuchs (2007: 82) observes, “the expending of resources, [or] getting access does not necessarily mean having influence.” Rather, identifying business’s sources of instrumental power helps us assess when and where business is more *likely* to exert influence, as well as the *mechanisms* through which business can obtain influence.

Business will be able to achieve more significant and more consistent influence when it possesses strong and multiple sources of instrumental power. The more resources business has at its disposal, the more numerous and advantageous its relations with decision-makers, and the more decision-making arenas in which these relationships operate, the more effectively business can lobby or mobilize in other ways, and the more available channels through which influence can flow. However, this is not a simple additive model; a single strong source of instrumental power may be sufficient for business to block a reform that it opposes.

Various factors can augment or attenuate business’s ability to achieve influence given a particular set of sources of instrumental power. Institutional constraints on reform in the form of constitutional protections, such as congressional supermajority requirements, can augment instrumental power. In addition, business may be able to form circumstantial alliances with other political actors or policymakers that enhance influence based on fortuitous convergences of interests. For example, politicians may be able to advance personal interests at certain points in time by promoting business interests, even if their relationships with members of the business sector do not consistently afford business strong instrumental power. In contrast, some government reform strategies can attenuate business influence and facilitate reform, even when instrumental power is strong. For example, it may be possible to make politicians less

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<sup>2</sup>His remaining channels of influence are consultative councils, corporatist bargaining, and corruption. In my framework, consultative councils and corporatist bargaining fall under the broader category of institutionalized consultation. Corruption, e.g. bribing policymakers, is an action requiring financial resources that lies outside the scope of this study. Somewhat confusingly, Schneider’s (2009) subsequent discussion is organized under a similar but distinct set of “activities”: associations and consultative councils, legislative lobbying, “electoral politics, parties, and campaign contributions,” networks, and corruption.

<sup>3</sup>Likewise, Fuchs (2007: 74) discusses a set of business resources similar to those I identify: financial, organizational, technical, and human resources. Like Schneider, however, she does not systematically discuss the mechanisms through which these resources may help business achieve influence.

responsive to business by mobilizing popular support in favor of reform, thereby counterbalancing business pressure. (Reform strategies are discussed in detail later in this chapter.)

Instrumental power can give business influence at several different stages of the policy process. Once a proposal has been announced, lobbying can mobilize government officials or politicians with whom business enjoys favorable relationships to obtain concessions or to block legislation in congress. Authors who apply the business power framework usually discuss the effects of instrumental power during these later stages of policymaking, and they tend to view instrumental power as influencing policy through “direct” or “overt” means. Fuchs (2007: 56), for example, observes: “Instrumentalist approaches to power... focus on the direct influence of an actor on another actor.” Similarly, Hacker and Pierson (2002: 280) note: “For instrumentalists, the power of business stems from its ability... to exert direct influence on government decisions.”

Instrumental power can also indirectly influence the reform agenda, a possibility that these authors do not explicitly consider (Smith 2000: 115-141, Hacker and Pierson 2002: 279-286, Fuchs 2007: 56-58, 71-95).<sup>4</sup> When business has strong and/or multiple sources of instrumental power at its disposal, policymakers may anticipate that attempting a given reform will entail a major political battle, and they may rule it out as politically infeasible or not worth the effort. In this case, it is the mere anticipation of business mobilization that keeps a reform off the agenda; business need not actively expend resources to achieve influence. Although business influence after a reform proposal has been announced is often much more easily observed, influence over the reform agenda can be much more important. As Hacker and Pierson (2002: 284) observe:

...the most significant aspect of influence involves moving the decision-making agenda toward an actor’s preferred end of the spectrum. ...focusing only on the actual conflict between contending alternatives may give a very misleading impression of an actor’s relative influence.

Therefore, examining whether or not instrumental power restricts the scope of the reform agenda is critical for assessing the extent to which instrumental power influences tax policy.

### **Relationships with Decision-Makers**

Four sources of power—recruitment, informal ties, institutionalized consultation, and partisan linkages—form the basis for relationships between business and decision-makers that may grant business privileged access and create bias in favor of business interests. Figure 2.3 displays the mechanisms through which business achieves influence in each case.

**Figure 2.3: Sources of Instrumental Power: Relationships with Decision-Makers**

<b>Source of Power</b>	<b>Primary Mechanism of Influence</b>
<b>Recruitment</b>	Participation in policymaking
<b>Informal Ties</b>	Decision-makers advocate for business interests
<b>Institutionalized Consultation</b>	Incentives for decision-makers to cede in areas affecting core business interests
<b>Partisan Linkages</b>	Representation of business interests

<sup>4</sup>These authors treat structural power (see next section) as the means through which business can exert “indirect” influence over the agenda. Fuchs (2007: 58, 64) in fact equates agenda-setting power with structural power. She writes that: “In contrast to instrumentalist approaches... structuralist approaches emphasize the input side of policy and politics and the predetermination of the behavioral options of political decision-makers.”

### ***Recruitment and Informal Ties***

Recruitment entails inclusion of businesspeople either in the executive branch, via appointments to ministries or in some cases direct election to the presidency, or in the legislature, through election on party tickets. Recruitment, particularly into government (e.g. the executive branch), is a classic source of instrumental power discussed by original authors of the concept (Miliband 1969: 54-57). Contemporary scholars including Schneider (2009: 7) and Arce (2005: 44-5, 68-9) have noted the importance of government appointments for business influence in Latin America.

When business leaders are recruited into government or hold elected offices, they are likely to pursue or advocate policies that favor private enterprise or the specific sector with which they identify.<sup>5</sup> However, a decision-maker's business background does not necessarily determine his or her policy preferences.<sup>6</sup> Businesspeople in the executive branch or congress may honor personal loyalties to a president or party whose policy goals are autonomous from business's views or coincide with the goals of particular sectors but conflict with those of other sectors. Therefore, it is important to examine not only whether or not businesspeople occupy high positions in government or congress, but also where their sympathies lie and what goals they prioritize when designing reforms.

Informal ties to government officials or legislators are a source of power similar to recruitment into government; however, the nexus of business linkages to decision-makers is a step further removed. In this case, business actors themselves are not among the decision-makers; rather, business has easy access to and sympathy from executive branch officials or legislators. These decision-makers may in turn advocate policies that business favors. Many authors, including Silva (1996), Weyland (1996: 59), Schamis (2002), Teichman (2001), Arce (2005), and Schneider (2009: 18-19), have associated informal ties to policymakers (sometimes referred to as networks) with business influence in Latin America.

Informal ties can take different forms and may arise in various ways. Informal ties may exist prior to an official's tenure in government or congress, thanks to common social circles or professional networks. In Latin America, as Schneider (2009: 18) observes: "high socio-economic stratification and geographic concentration in capital cities facilitate the formation of elite networks." Further, ministers often have pre-established professional networks or friendships with businesspeople, since prior experience with the sectors they will oversee may be viewed as a qualification for the job. Informal ties may also develop over the course of an official's tenure in government, through regular, long-term interactions between ministers and business representatives.

Decision-makers with informal ties to business are more likely to advocate on behalf of business interests than those who lack such ties. Due to socialization or self-selection, decision-makers who share common professional or social networks with businesspeople are more likely to share similar positions on policy issues. Personal friendships with businesspeople may give government officials extra motivation to advocate for policies that favor business. Mills (1956) and Miliband (1969), and others including Domhoff (1983, 1990), theorized in this vein that extraction from a common social circle or socioeconomic class could afford business influence over members of government and heads of state institutions, even in the absence of direct participation in those policymaking arenas. Mills (1956: 278), for example, writes:

The power elite, as we conceive it, rests upon the similarity of its personnel, and their personal and official relations with one another, upon their social and psychological affinities. In order to grasp the personal and social basis of the power elite's unity, we have first to remind ourselves of the facts of origin, career, and style of life of each of the types of circle whose members compose the power elite.<sup>7</sup>

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<sup>5</sup>In extreme cases, recruitment into state agencies may result in state capture.

<sup>6</sup>Conaghan and Malloy (1994: 151), for example, observe: "To businessmen of the Central Andes [in the 1980s], ...conservative governments showed that just putting your men in office was not enough—it did not guarantee palatable economic policy or a privileged position within the inner sanctum of policymaking."

<sup>7</sup>Subsequent literature rejected the notion of the "power elite" on the grounds that it overestimated the homogeneity of interests within the business community and between business and state actors (Schwartz 1985: 162-163, Hacker and Pierson 2002: 280).

Miliband (1969: 59), meanwhile, emphasized shared interests arising from common class origins of business elites and state elites:

Notwithstanding the substantial participation of businessmen in the business of the state, it is however true that they have never constituted... more than a relatively small minority of the state elites as a whole... However, the significance of this relative distance of businessmen from the state system is markedly reduced by the social composition of the state elite proper. For businessmen belong, in economic and social terms, to the upper and middle classes, and it is also from these classes that the members of the state elites are predominantly, not to say overwhelmingly, drawn.

However, similar caveats apply as in the case of recruitment; decision-makers with informal ties to business may maintain independent policy positions.

In general, business influence arising from informal ties or recruitment tends to be highly contingent and dependent on particular characteristics of the specific policymakers in question and the institutional environments in which they operate. For example, the effectiveness of informal ties or recruitment into government may depend on the nature of state institutions.<sup>8</sup> If the state is characterized by a Weberian bureaucracy, associated incentives for policymakers and bureaucrats to pursue common developmental goals may make them less responsive to business demands that are inconsistent with those goals, regardless of informal ties to business. Following Evans (1995, 1997), informal ties in these circumstances could even empower state decision-makers to better implement developmental agendas.<sup>9</sup> In the absence of a Weberian bureaucracy, however, informal ties could lead to state capture: “When the state lacks the capacity to monitor and discipline individual incumbents, every relationship between a state official and a businessperson is another opportunity to generate rents for the individuals involved...” (Evans 1997: 66). Turning to the legislature, the degree to which informal ties serve as effective sources of instrumental power for business may depend on characteristics of the country’s electoral system. Eaton (2002) argues that where electoral institutions create career-based incentives for legislators to demonstrate loyalty to party leaders, legislators will tend to be unreceptive to interest group pressures that run counter to the policy initiatives promoted by the party. In contrast, where electoral institutions “encourage legislators to cultivate personal reputations,” (Eaton 2002: 15), legislators may be much more responsive to business demands. Accordingly, informal ties to legislators may be a less effective source of instrumental power in party-centered electoral systems compared to candidate-centered electoral systems.

Both informal ties and recruitment are likely to create instrumental power at a sector-specific or even more disaggregated level, rather than a cross-sectoral level, since these sources of power involve relationships between individuals who may not be bound to represent aggregate interests. Schneider (2009) and other authors have observed that business-policymaker networks are likely to give voice to narrow and particularistic business interests as opposed to interests shared by the business community more broadly. For example, with regard to recruitment into parties and participation as legislators, Schenieder (2004: 246) finds that in Brazil: “The scores of ‘business deputies’ in Congress and in major political parties did not have a dramatic influence on collective business representation....” Likewise, (Arce 2006: 44) finds that appointments of businesspeople to state positions in Peru under Fujimori “facilitated collusion and selective rent-seeking behavior.” And Conaghan and Malloy (1994: 67) find that in Bolivia, recruitment of businessmen from the mining sector into government under Banzer in the 1970s “did not translate into a systematic representation of interests for the sector.”

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My purpose is not to advocate a power elite approach, but rather to emphasize that informal ties to government officials provide one means through which business may achieve influence over policy.

<sup>8</sup>This idea builds on Evans’ (1997: 66) observation that: “Government-business relations cannot be interpreted without first specifying the internal structure of the state.”

<sup>9</sup>This is a key element of Evan’s work on embedded autonomy: “When the state apparatus has the corporate coherence [Weberian bureaucracy] necessary to pursue collective goals, dense ties with the business community can become vehicles for the construction of joint public-private projects in pursuit of economic transformation,” (Evans 1997: 66).

The strength of instrumental power arising from informal ties and/or recruitment into government depends in part on how much authority the officials in question have over the policy area of interest. For example, appointments or informal ties to the Finance Ministry may afford stronger instrumental power with respect to tax policy than appointments or informal ties to sectoral ministries. And ties to the executive branch are likely to be stronger sources of instrumental power over tax policy than ties to legislators in countries where the executive enjoys strong economic policymaking prerogatives, as in the countries examined in this study. Further, the more pervasive business appointments or connections, the stronger business's instrumental power will likely be.

Instrumental power arising from recruitment or informal ties may be highly variable over relatively short time-periods. Elections can alter the number and identity of legislators with ties to business. And cabinet appointments usually change when a new administration assumes office. Turnover in executive appointments can even take place during the term of a single administration.<sup>10</sup> The structure of authority within the executive branch may also vary across administrations. While some presidents may consult with cabinet members and provide opportunities for them to advocate on behalf of business interests, other presidents may manage their administrations in a top-down manner, mandating that ministers carry out pre-formulated policy objectives. External factors such as economic crises can also produce shifts in authority within the executive branch that may affect instrumental power. For example, the finance minister may gain authority relative to sectoral ministers when the state urgently needs revenue.

### ***Institutionalized Consultation***

Institutionalized consultation, or *concertation*, as is it often called in literature on Latin America (Schneider 1997: 200), entails regular meetings between government officials and business association leaders. Concertation is similar to tripartite bargaining between government, business, and labor in European corporatism, except that labor need not participate—consultation or concertation in this study describes only the relationship between government and business. Institutionalized consultation differs from corporatism during the mid-20<sup>th</sup> century in Latin America in that it involves autonomous business associations with voluntary membership, rather than state-mandated and controlled business associations (Schneider 2004: 60).<sup>11</sup> Institutionalized government-business consultation may take place in councils or other formal bodies, or it may proceed more informally through regular interactions between top-level policymakers and business association leaders, as in Chile and Mexico (Silva 1996, Schneider 2004, Schneider 2009).

In addition to granting business regular access to policymakers, institutionalized consultation can create incentives for the government to cede on issues that affect core business interests. In general, institutionalized consultation may create incentives for business to compromise with government, as well as incentives for government to compromise with business; as Schneider (1997: 214) argues: “Concertation, or listening to business voice, does not mean simply a zero-sum loss of state autonomy or power to business.” However, when consultation is well-established in multiple domains, conflict with business over sensitive core interests may create unwanted tension or even disrupt mutually beneficial collaboration in other policy areas. Since concertation may improve economic governance and contribute to successful policy implementation (Schneider 1997: 200-212; Schneider 2004: 210-234), governments may have strong incentives to avoid reforms that threaten business's core interests. These incentives may be particularly strong where concertation excludes labor, an actor that might otherwise be able to counterbalance business interests in this policymaking venue.

Institutionalized consultation requires a well-organized business sector (Schneider 1997: 201), which gives rise to two implications. First, since peak associations aggregate business interests, institutionalized consultation tends to generate instrumental power at the sectoral level, or higher if there is a strong economy-wide business association. Second, institutionalized consultation may develop over fairly long time-periods and likewise may be a relatively stable source of instrumental power. Business

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<sup>10</sup>See for example Arce's (2005: 68) discussion of changing business influence in Peru during the mid-1990s.

<sup>11</sup>See also Schneider (1997: 60-66) on state corporatism and business in Mexico.

associations emerge as a result of long-term investment by business actors, often in response to incentives provided by the state, such as access to policymakers, or major threats to core interests like property rights (Schneider 2004: 20-39). Although institutionalized consultation develops and tends to persist over time, it may be disrupted by destabilizing factors such as the arrival of new political actors in government.

Institutionalized consultation may take place between business associations and the legislative branch, as well as the executive branch. In all countries included in this study, congressional finance committees regularly invited business representatives to present their positions on tax bills, and in some cases, committee hearings became a key venue of political struggle. However, when the executive's legislative powers and/or de-facto authority over economic policy formulation are much stronger than those of congress, as in the countries examined in this study, institutionalized consultation with committees is a much weaker source of instrumental power than institutionalized consultation with the executive branch. Consultation between business and congressional committees in these cases does not create incentives for legislators to cede on core business interests in part because legislators' initiative on economic policy and the scope of their participation in policymaking is much more limited than that of the executive. Instead, institutionalized consultation with congressional committees serves primarily as a formal channel of business access to legislators.

### ***Partisan Linkages***

I use the term partisan linkages to describe the relationship between business and politicians from conservative or right-wing parties whose core constituencies belong to upper-income groups. Following Gibson (1992: 15), "A party's core constituencies are those sectors of society that are most important to its political agenda and resources. Their importance lies not necessarily in the number of votes they represent, but in their influence on the party's agenda and capacities for political action."<sup>12</sup> Conservative parties by necessity seek to build multi-class coalitions in order to construct electoral majorities. However, the core constituency sits at the top of the coalitional hierarchy: "A party's core constituencies will be more important to the shaping of a party's political agenda, particularly for high-stake issues, than non-core constituencies. They will also play a more important role in the provision of financial and ideological resources," (Gibson 1996: 10). Miliband (1969: 187) described conservative parties and their relationship to business in similar terms:

...conservative parties for all their acceptance of piecemeal reform and their rhetoric of classlessness, remain primarily the defense organizations, in the political field, of business and property. ...The membership of these parties, and many of their activists, may be drawn from a wide cross-section of the population. But their leading figures are nevertheless overwhelmingly drawn from the upper and middle classes and generally include a substantial proportion of businessmen.

One can conclude that business and upper-income groups are a party's core constituency when the party receives consistently high levels of electoral support or public endorsement from those groups, when they contribute significant financial resources to the party, and/or when there is "programmatic convergence" between the party and those groups, meaning that the party behaves in ways that are consistent with business's and upper-income individuals' policy preferences (Gibson 1996: 13-14).

Partisan linkages afford business influence through representation of their interests, either in government, if a right party controls the executive branch, or in the legislature, if a right party holds a significant number of seats. Since instrumental power based on partisan linkages depends on the electoral fortunes of the right, it may vary over the short-term in any given country. Instrumental power in the legislature from partisan linkages will of course be stronger when the right party holds more seats, although depending on the balance of power and coalitional dynamics, holding even a small block of seats may give a right party and hence business interests substantial influence.

Although right party politicians will usually have informal ties to businesspeople and may also include businesspeople among their ranks, partisan linkages are a more institutionalized relationship

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<sup>12</sup>See also Gibson (1996: 7).

between business and parties than informal ties or recruitment alone. Partisan linkage can therefore be expected to give business more systematic influence than purely informal ties to legislators or recruitment into parties. However, electoral considerations at times may compel right parties to stray from the preferences of their core constituencies, such that partisan linkages do not guarantee business influence on all issues at all times.

**Resources**

Cohesion, technical expertise, preferential media access and financial contributions are resources that enhance instrumental power by making lobbying involving any of the relationships discussed above more effective, and/or by further enhancing access to decision-makers. Figure 2.4 displays the primary mechanisms through which each resource may create or enhance instrumental power. Systematic analysis of media access and financial contributions lie outside the scope of this study due to practical considerations; however, I include brief discussions of these two resources below for completeness. Of the other two resources, I find that the presence or absence of cohesion is more important for understanding variation in instrumental power across the cases I examine.

**Figure 2.4: Sources of Instrumental Power: Resources**

<b>Source of Power</b>	<b>Mechanisms of Influence</b>
<b>Cohesion</b>	Legitimizes Demands, Strengthens Bargaining Position Facilitates Mobilization and Protest
<b>Technical Expertise</b>	Enhances Access, Legitimizes Demands, Makes Arguments More Persuasive
<b>Preferential Media Access</b>	Shapes Public Opinion, Creates Electoral Advantage for Right Parties
<b>Financial Contributions</b>	Buys Votes, Mobilizes Supporters in Congress, Strengthens Partisan Linkages, Creates Electoral Advantage for Right Parties

**Cohesion**

Cohesion describes business’s potential to form and sustain a united front and engage in collective action. When business can present a united opposition front, prospects for influencing policy tend to be stronger than if each sector independently opposes reform, or if only certain sectors protest.

Cohesion enhances the effectiveness of lobbying or other forms of mobilization through two mechanisms. First, cohesion strengthens business’s bargaining position with respect to policymakers. When business opposition is not coordinated, policymakers may be able to divide and conquer, negotiating acceptance from particular sectors or sub-sectors as needed. This logic applies at both the cross-sectoral and sectoral levels. Economy-wide cohesion strengthens business’s bargaining position on issues of cross-sectoral concern, while sectoral cohesion strengthens a sector’s bargaining position on issues that affect its interests.

Second, cohesion may confer legitimacy on business’s demands in the eyes of policymakers. In contrast, when opposition is uncoordinated or where no united front exists, the demands of any particular group that opposes reform may be dismissed as narrow and self-serving.<sup>13</sup> This dynamic may be

<sup>13</sup>In Chile, for example, Silva (1997: 169) observes that: “major lobbying initiatives had to be conducted in the name of the CPC [the economy-wide peak association], not of individual sectoral organizations. Otherwise, technocratic policymakers dismissed them on the basis that narrow, selfish, sectoral interests were attempting to undermine the general good.”



especially important when the tax in question is cross-sectoral; in the absence of economy-wide cohesion, the government can portray each sector as demanding special treatment and seeking to shift the tax burden onto other sectors. At the other extreme, if a tax affects a single sector, support from business more broadly may legitimate and amplify that sector's opposition.

The common-sense view that unity enhances business power appears frequently in literature on business, elites, and economic reforms. In his classic study of redistribution in Latin America, Ascher (1984: 40) finds that: "if a coalition of the wealthy is allowed to form, the results are likely to be devastating" for progressive reform. In contrast, he observes that redistribution is more feasible when elites are regionally or sectorally divided, because such divisions can be exploited to impede formation of a united elite opposition front. Frieden (1991: 33) makes a similar argument at the sectoral level: "The greater the internal cohesion of a sector, the more political pressure it can bring to bear and the more influence it has on policy. The more successful a sector is in coming together to make common demands on policymakers, the more powerful will be the pressure it can exert." Cooperation among capitalists is one important aspect of sectoral cohesion according to Frieden (1991: 33).<sup>14</sup> Vogel (1987) and Akard (1992) arrive at similar conclusions from examining the politics of regulation and taxation in the US. Vogel (1987: 395) observes that government officials can play different segments of business off against each other to their own advantage—a strategy that is much less likely to succeed if business opposition is cohesive. Akard (1992), meanwhile, argues that united, coordinated political action allowed business to achieve significant policy influence in the 1970s and 1980s.

I treat encompassing organization as the most important of various factors that contribute to cohesion. Strong economy-wide business associations foster cross-sectoral cohesion by forging consensus among their members (Schneider 2004) and acting with authority on their behalf. Economy-wide associations can serve as key interlocutors between government and business, coordinating business lobbying or other forms of collective action including protest. Likewise, strong sectoral peak associations can contribute to sectoral cohesion. Although collective action can take place in the absence of encompassing organization, it will be much easier to sustain a united front when such an organization exists. In short, organization provides an institutional backbone for cohesion.

Four additional factors—common identity, shared ideology, homogeneity, and concentration—also contribute to cohesion. A strong common identity that distinguishes the business class or economic elites more broadly from other socially constructed groups contributes to cohesion (Lieberman 2003: 16) by promoting solidarity within the business community. Shared ideology can promote cohesion by helping to define a common business identity or common interests. Frieden (1991: 40), for example, notes that shared ideology can form the glue that holds together otherwise heterogeneous groups.<sup>15</sup> Homogeneity of interests, whether due to a comparatively narrow range of private sector economic activities or other factors, makes it easier to sustain a united front (Olson 1965). Finally, concentration, that is, a relatively small number of dominant economic actors, is an oft-cited factor that promotes cohesion and facilitates collective action (Olson 1965, Frieden 1991: 34, Etchemendy 2004: 121-2).

### ***Technical Expertise***

Technical resources may take the form of business association research departments or think tanks staffed with economists and advisors trained at prestigious universities or reputable technical schools. In some cases, business association studies departments may achieve recognition in international circles that lend them even greater prestige (Heredia 2003: 97).

Technical expertise can be a prerequisite for access to policymakers.<sup>16</sup> For example, the executive branch may have little interest in consulting or engaging in concertation with business associations unless they can bring technical expertise to the table.

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<sup>14</sup>Frieden (1991) also emphasizes cooperation among labor and between labor and capital.

<sup>15</sup>Levi (1988: 21) also notes the importance of ideology for collective action.

<sup>16</sup>Bull (2008) makes this point with regard to business participation in trade treaty negotiations.

Further, the ability to draw on technical expertise can make lobbying more effective by legitimating business demands and making their arguments more persuasive. Command of technical criteria can help business frame its interests as congruent with the broader national interest in economic development, rather than as purely self-interested and profit-seeking. For example, Conaghan and Malloy (1994: 73) observe that business groups in the Central Andes during the 1970s and 1980s: “tried to project themselves as technocratic bodies, consciously seeking to shed the image of oligarchic clubs. This technocratic projection became an important component in the business groups’ lobbying of technocrats charged with making economic policy...”<sup>17</sup> Technical expertise may also help business craft more persuasive arguments for defending its interests. Instead of simply rejecting increased taxation as an unwanted burden, business may be able to present or frame its opposition in terms of technical concerns that policymakers share. Examples include arguing that eliminating tax credits leads to double-taxation, which orthodox economists view as inappropriate, or arguing that purchasing certain goods like homes constitutes an investment rather than consumption and should therefore be exempted from the VAT (see Chapter 4). Likewise, legislators may be more easily swayed when business lobbyists have strong technical credentials.

The degree to which business’s technical expertise helps legitimate demands and craft persuasive arguments depends on how much technical expertise of their own policymakers command, and whether or not both sets of actors subscribe to the same school of economic thought. On the one hand, policymakers with extensive technical training may quickly detect flaws in purportedly technical arguments crafted solely to legitimate business demands. On the other hand, orthodox policymakers are unlikely to be convinced by heterodox economic arguments, and vice versa.

Although technical expertise can be important, it does not play a central role in explaining variation in tax policy outcomes in the cases I examine. Most business associations of consequence enjoyed significant technical capacity, yet they sometimes obtained concessions from policymakers and sometimes did not, even when both sides espoused orthodox economic principles. Further, executive-branch policymakers in all cases were quite attuned to the possibility that technical language sometimes served to disguise demands with little actual technical merit.

### ***Preferential Media Access***

Authors dating back to Mills and Miliband (1960: 182, 221) have identified media access as a key source of power for business and elites. Mills (1956: 315) for example described media access as “among the most important of those increased means of power now at the disposal of elites of wealth and power...” Business may achieve media access thanks to abundant financial resources, or businesspeople may have informal ties to media owners or themselves own mass media operations (Gibson 1992: 31, Mills 1956: 315). Given the concentration of media ownership in Latin American democracies (Hughes and Lawson 2004: 23, Fox and Waisbord 2002: x, xi, xii), preferential media access for business elites could be quite relevant in the region.<sup>18</sup>

Media access gives business the potential to influence policy outcomes indirectly, by shaping public opinion. Editorials, biased reports, and large volumes of coverage may consciously or unconsciously persuade voters to adopt business’s positions.<sup>19</sup> To the degree that politicians are responsive to public opinion on a given issue, media access may affect the executive’s reform agenda and/or how legislators vote in congress. Of course, public opinion and the median voter do not necessarily influence policymaking. But where media coverage systematically favors business, business

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<sup>17</sup>Similarly, Silva (1997: 176) finds that in Chile, “The exchange of information on the basis of technical evaluations facilitated accommodation” between government and business. A business association informant asserted: “Ever since we began discussing policy on a more technical basis, we have had better relations with government, and better results,” (quoted in Silva 1997: 176).

<sup>18</sup>In Mexico, for example, Hughes and Lawson (2004: 99) find that “Commercial incentives continue to encourage the special treatment of private advertisers...” On media concentration and bias in favor of elites in El Salvador, see Wolf (2009).

<sup>19</sup>Smith (2000: 168) reviews literature that makes similar arguments. In the US, Smith (2000: Chapter 8) argues that business achieves media access by funding think tanks, whose spokespeople receive significant media attention based on their technical credentials.

may have an advantage over policymakers who seek to implement reforms that run counter to business interests.

In addition, preferential media access may benefit business by giving right parties an advantage in electoral campaigns (Gibson 1992: 31). Preferential media access may thus help business obtain partisan representation in the legislature or in the executive branch.

Although preferential media access is a potentially important source of instrumental power, systematic analysis of media coverage, its effect on public opinion, and politicians' responses to public opinion lie outside the scope of this research. Data restrictions as well as time limitations govern this choice; while print accounts of tax reform episodes are available in news archives, television coverage, which is arguably more widely viewed, is less accessible.

In none of the cases I examine, however, does available evidence suggest that preferential media access was a critical source of instrumental power on tax policy. In Chile, where business by many accounts did enjoy preferential media access, I will argue that other sources of instrumental power were much more important. Where business enjoyed favorable media coverage but did not have other sources of power, it achieved little influence, as in the case of Argentina's industrial association during the 1990s.<sup>20</sup> And where business did not have preferential access or favorable media coverage, other sources of instrumental power were sufficient for influencing tax policy, as in the case of finance in Argentina during the 1990s. Therefore, whereas Smith (2000: 10) maintains that in the US: "the most effective political strategy for a unified business community involves influencing public opinion," my findings suggest that in Latin America, other sources of instrumental power may be much more relevant.

### ***Money and Financial Contributions***

Money clearly enhances business's ability to invest in technical expertise, obtain media access, and sustain organization. Financial contributions afford business influence through a number of additional mechanisms. This source of power has been much studied in literature on US and European politics.<sup>21</sup> Recent work suggests that the role of money in politics and opportunities for business to influence outcomes through financial contributions have increased in developed countries (Hacker and Pierson 2007: 21). The limited evidence available for Latin America is consistent with this view. Costs of campaigns have increased in Latin America, and public financing, where it exists, cannot substitute for private donations (Samuels 2001, Zovatto 2003).<sup>22</sup>

Given practical constraints, systematic analysis of financial contributions lies outside the scope of this research. Obtaining information on campaign financing and donations in most Latin American countries is extremely difficult. Little if any data is publicly available, and the topic is extremely sensitive given the lack of transparency and potential for corruption that characterize the relationship between money and politics in much of the region.<sup>23</sup> Nevertheless, I briefly review several mechanisms through which financial contributions may enhance business influence.

First, financial contributions may grant business direct influence over politicians' votes through leverage in the form of promises for additional funding if business interests are addressed, or, conversely, threats to withhold funding if they are not. This logic seems intuitive and compelling in a world where campaigns are becoming more expensive and public financing is insufficient. Samuels (2001: 37) in fact finds anecdotal evidence that corporate campaign contributions in Brazil led to "apparent 'quid pro quos'" that afforded business influence over policy decisions.<sup>24</sup>

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<sup>20</sup>Schneider (2005: 193) observes that the Argentine industrial association's "greatest strength was its visibility in the press" in the 1990s; however, as will be demonstrated in Chapter 5, the association achieved little influence over tax policy.

<sup>21</sup>Fuchs (2007: 78-83) and Hall and Wayman (1990: 798) review some of this literature. See also Smith (2000:115-133).

<sup>22</sup>In Brazil, for example, Samuels (2001: 27, 34-35) finds that most of the money devoted to campaigns originates from business.

<sup>23</sup>For example, Posada-Carbó (2005: 7) emphasizes that: "very little is known about how much money is involved in the elections of these countries, or where the money is coming from." See also Garretón 2005, and Alvarez and Urbaneja 2005.

<sup>24</sup>Hall and Wayman (1990: 798), however, find little support for this hypothesis based on their review of research on financial contributions and roll-call votes in the US Congress. They point out that if financial contributions were intended to directly influence votes, they would accrue disproportionately to swing voters, yet the authors do not observe that outcome empirically.

Hall and Wayman (1990: 814) identify a second way in which financial donations may allow business to influence policy: mobilizing bias in congress: “Moneyed interests are able to mobilize legislators already predisposed to support the group’s position;” money buys “the marginal time, energy, and legislative resources that committee participation requires.” In this manner, financial donations help business shape the legislative agenda (Hall and Wayman 1990: 802). This mechanism is probably less relevant in Latin American countries where the executive has much more control over the tax agenda than the legislature. However, financial donations to presidential candidates or their parties may well help business influence the executive’s agenda, encouraging the government to pay attention to some issues and set others aside.

A third manner in which financial donations may enhance instrumental power is by giving right party candidates an electoral advantage. While business may donate to all major candidates (Schneider 2009: 17), contributions to right parties will likely be much more substantial; as Gibson (1992) notes, financial contributions serve as an important component of the core constituency relationship between business and right parties. Samuels (2001: 38-9, 41, 43) confirms the importance of this electoral mechanism of influence in Brazil; he finds that left parties receive significantly less corporate funding than non-left parties, and that campaign contributions have a large effect on the outcome of elections.

### Structural Power

Structural power arises from policymakers’ expectations about the aggregate effects of individual economic behavior. Lindblom (1977, 1984) and Block (1977) argued that in market democracies, capitalists, who invest based on the logic of profitability, have effective veto power over economic policy. When reforms curtail profits or eliminate investment incentives, capitalists may respond by reducing investment, which generates automatic and unintentional punishment:

Any change or reform they do not like brings to all of us the punishment of unemployment or a sluggish economy. ...the system works that way not because business people conspire or plan to punish us, but simply because many kinds of institutional changes are of a character they do not like and consequently reduce the inducements we count on to motivate them to provide jobs and perform their other functions. (Lindblom 1982: 327).

Public officials subsequently pay the price for reduced prosperity at the polls: “When a decline in prosperity and employment is brought about by decisions of corporate and other business executives it is not they but government officials who consequently are retired from their offices,” (Lindblom 1982: 329). Anticipating this scenario, policymakers avoid reforms that business opposes.<sup>25</sup> In contrast to instrumental power, structural power does not require elites to engage in any voluntary political action to influence policy. Instead, market signals coordinate investors in the economic arena. Accordingly, as Hacker and Pierson (2002: 281) observe: “the pressure to protect business interests is generated automatically and apolitically. It results from private, individual investment decisions taken in thousands of enterprises, rather than from any organized effort to influence policy makers.”

In my operationalization, structural power arises from an anticipated *disinvestment threat*—a perceived threat that reform, or the mere announcement of a reform proposal,<sup>26</sup> would lead to a significant reduction in investment in a particular sector or in the domestic economy more broadly.<sup>27</sup> A credible disinvestment threat requires that private sector agents have incentives, not just the ability, to reduce investment. Such incentives depend on how much the reform in question affects profits or the perceived security of investments, as well as expected returns on the other investment options that are available and

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<sup>25</sup>Similarly, Block (1977: 15) argues: “In a capitalist economy the level of economic activity is largely determined by private investment decisions of capitalists. This means that capitalists, in their collective role as investors, have a veto over state policies in that their failure to invest at adequate levels can create major political problems for state managers.”

<sup>26</sup>See Przeworski and Wallerstein (1988: 22). Based on analysis of a formal model, they conclude that capitalists’ anticipation of tax increases in some cases can lead to reduced investment during the period running up to implementation. Their model is based on profit-maximizing behavior and is explicitly designed to investigate the extent to which structural power constrains policy.

<sup>27</sup>Structural power may also arise from a *non-investment threat*—stagnation of investment at prevailing levels.

transaction cost associated with shifting assets (Mahon 1996: 21). Certain reforms may create strong incentives to seek out alternative investment options, whereas others may not. If a policy change makes some forms of investment less desirable and capital is mobile, the reform may create an *exit threat*. If capital is not mobile, but the reform produces strong disinvestment incentives, it may generate a *withholding threat*,<sup>28</sup> where it is anticipated that capitalists will refrain from investing. The more credible policymakers perceive a disinvestment threat to be and the greater the potential magnitude and/or impact of disinvestment, the stronger structural power will be.

More broadly, structural power may arise not only from a disinvestment threat, but also from the threat of disruption of other activities in which capital owners engage as part of their normal productive operations, such as commercialization of goods. For example, business owners may shut down shops or factories, fail to deliver inputs, or refrain from selling final products. Just as disinvestment or non-investment may threaten growth and employment, disruption of other productive activities (withholding other aspects of production) can create negative economic consequences that policymakers will seek to avoid. The discussion that follows also applies to this broader understanding of structural power.

Structural power usually acts by restricting the agenda. If policymakers anticipate that a reform will cause investment to decline, they may rule it out for fear of harming growth and employment. However, structural power may also come into play at later stages of policymaking. For example, legislators might reject a reform for fear of negative economic consequences, even if policymakers in the executive branch who designed the reform believe it does not pose any risk of reduced investment.

If policymakers do not anticipate a disinvestment threat, structural power is weak and will have no effect on whether or not a reform is proposed. However, if announcement of a reform proposal in fact provokes reduced investment, then structural power in the form of what I label a *realized disinvestment threat*—disinvestment that has actually occurred—may influence the fate of the initiative.<sup>29</sup> Alternatively, if the reform provokes or is perceived to have provoked reduced investment (or other negative economic consequences) after it has been implemented, structural power via a realized disinvestment threat could compel policymakers to amend or reverse the legislation thereafter.

Competing priorities can attenuate the effect of structural power. Policymakers may have other priorities that trump concerns over investment, even if they do anticipate that a reform will provoke disinvestment. For example, a leftist government might prioritize redistribution over growth, reestablishing fiscal discipline or solvency might take precedence over encouraging investment, or an administration might enact a reform to capitalize on popular support or to appease mobilized popular sectors. Other priorities may become less relevant as the perceived magnitude and impact of the disinvestment threat increases.

Predicting the aggregate economic effects of myriad individual investment decisions is not an exact science. Economists can model investors' behavior based on how a reform affects the profitability of different investment options. In practice, however, models depend on numerous assumptions that may or may not capture the reality of a complex situation, and experts often disagree on the likely consequences of a reform.

Disjunctures can therefore arise between policymakers' perceptions of a reform's likely impact on investment, and what the reform's actual consequences will be or would have been. On the one hand, policymakers might anticipate a significant disinvestment threat even if a reform is in fact unlikely to alter investors' behavior. On the other hand, policymakers might not anticipate disinvestment even when investors are likely to respond negatively to a reform.<sup>30</sup> As Hacker and Pierson (2002: 282) point out:

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<sup>28</sup>This distinction between withholding and exit threats builds on Winters (1996: 22), who differentiates between withdrawing investment, an option available to all investors, and relocating investment, which is possible only when capital is mobile. Of withdrawing investment, Winters (1996: 22) observes: "At its most dramatic a plant can be closed... At a much more subtle level an expansion, a new investment, or some kind of reinvestment can be postponed or canceled."

<sup>29</sup>Przeworski and Wallerstein (1988: 23) note that economic costs resulting from investors' anticipations of reform dissuaded the French Socialist Party from moving forward with announced legislation to protect renters, although they argue that in many such situations, investment may well resume after reforms are implemented.

<sup>30</sup>A case involving agro-export firms and a retroactive export tax increase in Argentina in 2002 is examined in Chapter 6, Part 2.

“structural power is a signaling device; by itself it does not dictate policy choices.” Under some conditions, policymakers may misread or simply fail to detect the signal. As will be discussed in the following section, instrumental power can play a role in creating disjunctures between policymakers’ anticipations and actual investment outcomes.

**Figure 2.5: Actual vs. Anticipated Disinvestment Threats and Influence via Structural Power**

		Actual Disinvestment Threat	
		High	Low
Anticipated Disinvestment Threat	High	<i>Anticipated Disinvestment Threat</i> keeps reform off agenda, unless other priorities prevail.	<i>Anticipated Disinvestment Threat</i> keeps reform off agenda, unless other priorities prevail.
	Low	Structural power does not affect reform agenda. <i>Realized Disinvestment Threat</i> may affect fate of proposal or duration of reform.	Structural power does not affect reform agenda, fate of proposal, or duration of reform.

A critical point emerges from the preceding discussion: identifying policymakers’ perceptions regarding the anticipated consequences of different reform alternatives, or their actual economic impact, and studying how policymakers make decisions is essential for identifying whether or not structural power influences policy. Some authors (particularly those accustomed to large-N analysis) dismiss structural power at the agenda-setting stage as essentially unobservable, given the presumed difficulty of identifying reform options that were never publicly discussed (Smith 2000: 149, Fuchs 2007: 59). However, interviews with decision-makers can provide strong evidence for establishing whether or not policymakers ruled out certain reforms for fear of reduced investment.

Structural power can vary across countries and across policy areas. Country-level factors such as technical details of the tax system, the broader policy environment maintained by the government (Hacker and Pierson 2002: 282, Gelleny and McCoy 2001), or a history of economic instability can affect investors’ incentives to withhold or exit in response to tax reforms. Therefore, similar reforms may create a credible disinvestment threat in one country but no such threat in another country. In addition, reforms in different policy areas can affect or convey different signals to investors with different types of assets (Maxfield 1997: 38-9). For example, investment in a certain sector or asset may be viewed as particularly risky and may therefore be sensitive to reforms with a relatively small impact on profits, whereas investment in another sector or asset may be so profitable that even substantial tax increases would not deter investment.<sup>31</sup> Likewise, investors may interpret some reforms as signals that their assets may no longer be secure, whereas other reforms may not trigger any such concerns.<sup>32</sup> Further, reforms affecting highly mobile capital are more likely to elicit credible disinvestment threats than reforms affecting sunken assets.

Structural power also varies over time. Since structural power ultimately depends on policymakers’ perceptions, one potential source of time variation is turnover in government. If new authorities subscribe to different economic principles than their predecessors, they may view a given reform as either more or less deleterious to investment than their predecessors assumed. Another important source of time variation is the state of the economy. Many authors have observed that structural power will be at its strongest during recessions, when policymakers tend to prioritize investment and job creation.<sup>33</sup>

<sup>31</sup>Fixed-time deposits in Argentina illustrate the former case; export taxes on soy illustrate the latter case (Chapter 6).

<sup>32</sup>Chapter 6, Part 1 will illustrate this point with respect to tax reforms affecting the financial sector in Argentina.

<sup>33</sup>Smith (2000: 148-9) for example, writes: “during economic downturns... politicians depend the most upon stimulating the economy to further their own electoral futures.”

However, economic crisis can reduce structural power (Block 1979, Akard 1992: 609, Hacker and Pierson 2002). Hacker and Pierson (2002: 297) point out that if investment has already fallen dramatically, as occurred during the Great Depression in the US, further disinvestment may be irrelevant:

Because private investment had already plummeted, the usual impact of ... implied or actual ... [disinvestment]<sup>34</sup> was diminished. To be sure, the Depression also hurt the federal government's fiscal standing and heightened political leaders' interest in fostering growth. Yet, on balance, the evaporation of private investment and loss of faith in reigning economic assumptions gave policy makers an unusual amount of room to maneuver.

Vogel (1987: 394) offers a synthesis of these two views. He argues that structural power will be weak when the economy is either in boom or in bust, but strong when intermediate conditions prevail. Although this relationship between structural power and economic cycles holds in various cases that I examine, in other cases, disinvestment threats exist even during times of strong economic growth.

Identifying the many dimensions across which it can vary helps to reclaim structural power as a useful analytical concept. As Hacker and Pierson (2002) observe, early expositions of the concept, including Lindblom's (1982) well-known formulation of the "market as prison," viewed structural power as extremely constraining and could not account for broad cross-national variation in economic policy regimes.<sup>35</sup> But careful analysis of how structural power varies over time, across policy areas, and across countries does give purchase for explaining tax policy outcomes.<sup>36</sup>

### **The Relationship Between Instrumental Power and Structural Power**

Business will be particularly strong when both instrumental power and structural power are present. The two forms of power may have additive effects. They may also interact in mutually reinforcing ways. Nevertheless, I stress that structural and instrumental power are conceptually distinct and independent, although other literature does not always treat them as such.

When business enjoys both structural power and instrumental power, it can achieve more consistent and more substantial influence. In these cases, business can exert influence through multiple channels; where one means fails to achieve the goal, another may succeed. For example, if structural power does not prevent policymakers from proposing a reform business opposes, instrumental power may allow business to obtain concessions later on in the policymaking process.

Moreover, instrumental power and structural power can be mutually reinforcing—each may be stronger in the presence of the other. On the one hand, lobbying (instrumental power) can augment policymakers' perceptions that a reform will cause disinvestment (structural power). It is even possible that lobbying could convince policymakers that there is a credible threat of disinvestment when they

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<sup>34</sup>Hacker and Pierson use the term "investment strike" here, but as discussed in the following section, my definition of this term differs from their usage. I omit their reference to this term to avoid confusion.

<sup>35</sup>Lindblom (1982: 326) asserts: "One line of reform after another is blocked by prospective punishment. An enormous variety of reforms do in fact undercut business expectations of profitability and do therefore reduce employment." Similarly, he holds that: "change in business and market institutions is drastically repressed by the frequency with which change will in actual fact produce unemployment," (Lindblom 1982: 327).

<sup>36</sup>Lindblom's failure to problematize the extent to which disinvestment is in fact likely and the conditions under which policymakers will perceive disinvestment threats as credible may explain why he portrays structural power as monolithic and invariant. He asserts that in order to influence policy, businessmen "need only point to the costs of doing business, the state of the economy, the dependence of the economy's stability and growth on their profits or sales prospects—and simply predict, not threaten, that adverse consequences will follow on a refusal of their demands," (Lindblom 1977: 185). Lindblom (1977: 185) places significant weight on business's predictions regarding investment: "Prophecies of some kinds tend to be self-fulfilling. If spokesmen for businessmen predict that new investment will lag without tax relief, it is only one short step to corporate decisions that put off investment until tax relief is granted." As discussed above, however, a particular policy's effect on investment behavior may not be clear-cut, and if many investors are involved, it is problematic to assume that what a particular business leader (even a prestigious one) predicts will in fact ensue, although such signaling effects could be important. Moreover, policymakers may not unquestioningly accept business's arguments that reforms will harm investment. Government officials and technocrats in charge of formulating economic policy usually have sufficient technical expertise to independently assess the economic impact of reforms under consideration.

harbor no preexisting concerns regarding a reform's impact. This situation might arise when policymakers lack sufficient technical expertise to independently evaluate business' self-interested assertions that a reform will deter investment and growth.<sup>37</sup>

On the other hand, structural power can augment instrumental power. For example, decision-makers may grant business more extensive access and participation when they are concerned that a certain policy may affect investment.<sup>38</sup> Lindblom's (1977: 170-188) discussion of the privileged position of business is consistent with this view. He argues that public officials grant business privileged access to decision-making arenas—which confers instrumental power—because business makes the decisions that determine growth and employment—in other words, because capital wields structural power:

Any government official who understands the requirements of his position and the responsibilities that market-oriented systems throw on businessmen will therefore grant them a privileged position. He does not have to be bribed, duped, or pressured to do so. ...Businessmen cannot be left knocking at the doors of the political systems, they must be invited in. (Lindblom 1977: 174-5)

At one extreme, business might be recruited into government in order to re-establish investor confidence and thereby diminish threats of disinvestment associated with business's expectations about an administration's preferred policy agenda.<sup>39</sup>

Despite the fact that instrumental and structural power may interact in mutually reinforcing ways, it is important to recognize that they are nevertheless conceptually distinct. Instrumental power involves deliberate and often collective action in the political arena, whereas structural power entails apolitical, market-coordinated decisions in the economic arena. Accordingly, structural power and instrumental power need not covary. Structural power may be strong even if instrumental power is weak, and instrumental power can be strong in the absence of structural power.

However, a clear distinction is not always made between structural and instrumental power in literature on business and politics. Etchemendy (2004), for example, defines structural power as “the value that industrial sectors generate in relation to their degree of concentration,” (Etchemendy 2004: 121-122). Etchemendy (2004: 122-3) treats the value of sales and profits as an indicator of a sector's lobbying capacity, since larger firms will have more resources to deploy for this purpose (for example, full time staff devoted to policy analysis and lobbying). Similarly, high concentration (dominance of a sector by a small number of large firms) indicates lower obstacles to collective action, following an Olsonian logic, and hence greater lobbying capacity. Since lobbying capacity falls within the realm of instrumental power, structural power as Etchemendy defines it acts exclusively by producing instrumental power. His treatment is therefore distinct from traditional conceptualizations, which focus on the automatic and apolitical manner in which structural power influences policy decisions. In fact, his definition of structural power involves proxies for resource-based sources of instrumental power discussed previously (cohesion, financial resources, and technical resources).

Handley's (2008) treatment of structural power with regard to business in Africa also departs from the classic definition. She defines structural power as “the power that comes from the private sector's weight in the economy,” (Handley 208: 10). While controlling a substantial share of the economy may be a prerequisite for business to wield structural power in the classic sense of the term, the size of the private sector alone clearly does not indicate that structural power is strong or that business will be able to achieve influence on any particular policy issue. Similarly to Etchemendy, Handley's (2008: 10-11) definition of structural power is confounded with instrumental power, given that she treats weight in the

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<sup>37</sup>However, business's arguments that a reform will harm investment are most likely to be effective when policymakers already harbor some such concerns.

<sup>38</sup>Silva (1997: 177) follows this logic with respect to business influence in Chile in the 1990. He argues that the government's concerns regarding investment and growth in the immediate aftermath of the transition to democracy motivated it to consult closely with business, which had supported the dictatorship, on all aspects of economic policy.

<sup>39</sup>For example, former Ecuadorian president Gutierrez campaigned on a leftist platform, but once in office, he appointed an orthodox economist supported by business as his finance minister in order to quell concerns over potential disinvestment (Campello 2009: 23).



economy, or alternatively, “an independent economic base,” as an indicator of business’s financial and organizational resources. In fact, her discussion makes no distinction whatsoever between “political capacity” and structural power.<sup>40</sup>

Particular care must be taken to distinguish instrumental power from structural power in cases where disinvestment or withholding of other aspects of production occurs in response to reform. If disinvestment is market-coordinated, in that individual firms or entrepreneurs are following a profit-maximizing logic, structural power is at work. However, disinvestment may also occur through *capital strikes*, a form of business protest that entails deliberate, politically-coordinated decisions to withhold investment or disrupt other productive activities in cases where individual participants have market-based incentives to continue their normal economic activities. Capital strikes fall within the realm of instrumental power because, like labor strikes, they require collective action. When a reform does not significantly alter market incentives, disinvestment or disruption of production would not occur in the absence of collective action. As such, withholding in the case of a capital strike is neither apolitical nor automatic. In contrast to market-coordinated disinvestment, capital strikes entail substantial short-term costs for the participants (Mahon 1996: 21),<sup>41</sup> and long-run gains will depend on how effective the protest is at influencing policy choices and/or politics more broadly. Short terms costs are perhaps most evident when capital strikes take the form of shop closures or employer lockouts; any individual business participant faces incentives to resume commercialization or production and capture sales forgone by other businesses.

It should be noted that many authors apply the term capital strike, or investment strike, to cases of market-coordinated disinvestment or withholding of other aspects of production (Winters 1996: 21-22, Hacker and Pierson 2002: 297, Campello 2009: 2).<sup>42</sup> These authors do not explicitly consider the possibility that disinvestment can be politically-coordinated. Distinguishing between market coordination and political coordination is important, however, because the mechanism through which withholding occurs may affect policymakers’ strategic calculations and hence whether or not the reform is subsequently adjusted or reversed. If disinvestment after a reform is announced or implemented entails political rather than market coordination, government policymakers may be less inclined to amend the reform in question. Instead, they may attempt to ride out the protest and wait for the logic of profitability to preempt the logic of collective action.

My treatment of a capital strike is consistent with Mahon (1996), although he does not employ the concepts of structural and instrumental power. He refers to a capital strike as “a class of political capital flows” in which “the asset decision is intended to change the relevant policies, maybe by bringing down the government,” (Mahon 1996: 20). In a capital strike, “Capital flight ...acts as a *deliberate* tool of pressure, as opposed to a method of increasing expected return,” (Mahon 1996: 21). In contrast to structural power, then, disinvestment in the case of a capital strike is neither apolitical nor automatic.

Although the primary case of withholding examined in this study entailed purely instrumental power (the agricultural producers’ capital strike in Argentina, Chapter 6, Part 2), real world cases of disinvestment may involve elements of both structural power and instrumental power. Business actors may attempt to organize capital strikes in cases where market-coordinated disinvestment is already taking place in order to augment their influence. For example, business staged capital strikes in Chile in 1972 to

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<sup>40</sup>For example, Handley (2008: 11) asserts: “As a rule, the more business people rely on the functioning of the markets for their profitability, the greater their capacity (both as accumulators and political actors) will be.” Beyond this lack of conceptual clarity regarding the sources and means of business influence, Handley does not appear to systematically score “business capacity” across her country cases.

<sup>41</sup>Winters (1996: 22) also includes “costs and losses for individual investors that persist for the duration of the boycott” as a defining feature of capital strikes.

<sup>42</sup>Winters (1996: 22) makes no clear distinction between market coordination and political coordination. Further, he equates capital strikes or boycotts with withdrawing (withholding in my terminology) investment, as opposed to relocating investment. I do not adopt this view. Following my definition of a capital strike, relocating investment and withholding investment can both be part of a deliberate, coordinated effort by capital owners to bring about policy change. Furthermore, withholding can be a response to market signals, just like relocation—it may make economic sense to postpone investment or even close factories until better conditions prevail.

destabilized the Allende government, even though substantial disinvestment had already occurred in response to the government's transformative, redistributive policy agenda. Allende faced highly mobilized popular sectors that supported his moves toward socialism, and market-coordinated disinvestment alone was not enough to force him to abandon his project.<sup>43</sup> And business in India attempted to orchestrate a capital strike in 1947 and 1948 to force the government to abandon reforms that would regulate private investment for the sake of developmental goals (Chibber 2003: 142-5). This capital strike also took place in the context of market-coordinated disinvestment, probably caused by other problems of the postwar context in addition to the government's reform agenda (Chibber 2003: 142).

### Government Strategies for Reform

When business enjoys strong instrumental power and/or structural power, taxing elites will be a difficult challenge. However, governments seeking to implement equity-enhancing tax reforms, or revenue-raising tax reforms more broadly, can employ a variety of strategies to circumvent obstacles created by business power, and, more generally, to build support for legislating reforms that require approval in congress.

I classify strategies into two main categories relevant to reform design: *tax-side* and *benefit-side* strategies. Tax-side strategies exploit specific characteristics of the tax increase at hand. These strategies include *reducing impact*, *legitimizing appeals*, and *obfuscating incidence*. In contrast, benefit-side strategies aim to deflect debate away from the tax increase and focus attention instead on benefits produced by or associated with the tax increase or the broader reform package in which it is nested. These strategies include *compensation*, *emphasizing stabilization*, and *linking to social spending*. The familiar approach of dividing and conquering can combine elements of both tax-side and benefit-side strategies.

These strategies are often closely associated with the choice of particular tax instruments or the design of the broader reform package. A reform can be intentionally crafted to allow use of one or more strategies, or a particular policy design selected on the basis of other criteria may lend itself to certain strategies but preclude the use of others. Even if the executive does not deliberately employ any particular strategy, characteristics of a reform may activate dynamics associated with a certain strategy.

Reform strategies can circumvent business power through one or more of the following means: attenuating business influence, reducing business opposition, or reducing concerns over disinvestment. Attenuating influence and reducing opposition are relevant with respect to instrumental power. Some strategies attenuate influence by making politicians with whom business enjoys favorable relationships less responsive to business pressure, often by generating public support for reform. These strategies usually address the problem of winning votes for reform in the legislature. Strategies that reduce business opposition, in contrast, make instrumental power less relevant for determining the outcome of the reform in question. Business will only mobilize and actively employ its sources of instrumental power if it opposes the reform. If business is indifferent to the reform, strong instrumental power is of little consequence to the outcome. Finally, a few strategies can counteract structural power by using clever reform designs to avoid activating concerns over disinvestment or other negative economic consequences.

Each strategy has limitations and drawbacks that policymakers must take into account.<sup>44</sup> For example, some strategies may be mutually incompatible. Some strategies may entail fiscal cost. Some strategies work best in times of fiscal crisis. And some strategies are inherently difficult to execute. Nevertheless, among the cases examined in the following chapters, each strategy has facilitated reforms that otherwise may not have been possible.

Figure 2.6 locates each of the six strategies according to the two main design-related categories under which it falls (tax-side vs. benefit-side) and the primary means through which it helps to circumvent constraints imposed by business power.

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<sup>43</sup>See for example, Sigmund (1977: 177), Stallings (1978, 137), and Silva (1996).

<sup>44</sup>This framing follows Pierson (1994: 24-26).

**Figure 2.6: Means of Circumventing Business Power**

	Circumventing Instrumental Power		Circumventing Structural Power
	Attenuating Business Influence	Reducing Business Opposition	Reducing Concerns over Disinvestment
<b>Tax-Side Strategies</b>	Legitimizing Appeals	Some Legitimizing Appeals Attenuating Impact Obfuscating Incidence	Attenuating Impact Obfuscating Incidence
<b>Benefit-Side Strategies</b>	Linking to Social Spending	Compensation Emphasizing Stabilization	Compensation

### **Tax-Side Strategies**

Reducing the impact of tax increases, obfuscating tax incidence, and appealing to widely shared norms or values to legitimize tax increases are three tax-side strategies that differ in the means through which they undermine business power. Attenuating impact can reduce business’s opposition to reform. Obfuscating incidence can attenuate influence via instrumental power, or it can reduce concerns over disinvestment. Legitimizing appeals, which can be based on vertical equity, horizontal equity, and/or nationalism, usually attenuate influence, although horizontal equity appeals can also reduce business opposition.

### ***Attenuating Impact***

This strategy draws on the common-sense observation that business and upper-income individuals will be less opposed to a tax increase the smaller its impact on their profits or pocket-books. Similarly, concerns regarding the impact of a tax reform on investment may decline as its impact decreases.

Various temporal reform design techniques, including phase-ins, incremental tax increases, and time-limits, can attenuate impact on elites.<sup>45</sup> A tax increase can be phased in gradually over time. Similarly, an administration can pursue a series of incremental tax increases spread out over time rather than attempting to legislate a single more significant reform. A tax increase can also be legislated to hold effect for a limited time period. Each of those techniques can make business more willing to accept a tax increase that would otherwise be opposed. However, these approaches have the obvious drawback that they entail fiscal costs. If an administration needs significant revenue in the short-term, phase-ins and incremental increases may not be desirable or feasible. If an administration faces permanent revenue needs, temporary reforms may be undesirable.

Another technique, which I label diffusion, entails spreading the tax burden over a number of different sectors or groups. For example, instead of attempting to extract a significant amount of revenue from a single, historically under-taxed sector, the executive might opt for a cross-sectoral corporate tax increase that has only a moderate impact on any given sector. However, attenuation through diffusion may pose the tradeoff of antagonizing multiple groups; Ascher (1984) among others emphasizes the importance of not opening too many fronts of conflict at once. Diffusion through amalgamation of multiple sector-specific tax increases may be the most problematic approach from this point of view, depending on whether or not the sector in question enjoy strong instrumental power, given that sector-specific reforms tend to elicit intense opposition from those affected (Olson 1965, Weyland 1997: 56).

<sup>45</sup>These strategies have been common in Chile (Chapter 4).

### **Obfuscating Incidence**

Obfuscating tax incidence<sup>46</sup> entails reducing taxpayers' awareness of paying the burden. This strategy can eliminate concerns regarding disinvestment that might otherwise create structural power. Investors will not react to a tax increase if they are not conscious of its effects. Reducing taxpayers' awareness of the burden can also circumvent instrumental power by reducing business opposition to the tax increase. Ascher (1984: 228) anticipates this strategy when he observes: "Clarity, when it mobilizes a powerful opposition, is counterproductive" for redistributive reforms.<sup>47</sup>

Reducing taxpayers' awareness of the tax burden entails selecting taxes with low *visibility* (Steinmo 1993: 19, Wilensky 2002: 379-381).<sup>48</sup> Direct taxes on income or assets tend to be highly visible. When individuals are required to file tax returns and pay out of pocket, they are acutely aware of the tax burden imposed upon them. The VAT, in contrast, is the archetypical example of a low-visibility tax. Because the VAT is hidden within the final price of the good or service, consumers do not tend to notice the tax burden.<sup>49</sup> Employers' social security contributions have low visibility as well (Steinmo 1993: 19). Employers pass on the cost of these taxes to employees through lower wages. Precisely because these taxes are collected from employers, however, wage earners generally are not aware that they bear the tax burden. This example illustrates one technique for reducing the visibility of a tax: exploiting the phenomenon of burden-shifting, which stems from "the difference between the *de jure* and *de facto* incidence of taxes," (Pierson 1994: 21).

Obfuscating strategies suffer from a number of limitations and drawbacks. First, reducing visibility can introduce actual uncertainty regarding incidence. Experts may not agree on what the reform's actual distributional consequences will be. For example, it may not be clear whether or not the economic assumptions required to successfully exploit burden-shifting actually hold (e.g. perfectly competitive markets). If a reform's incidence becomes too uncertain, business is likely to strongly oppose it because of the difficulties it creates for planning future investments. As Ascher (1989: 464) observes: "The frequently negative 'reflex' reaction to a new tax reform initiative on the part of many groups is typically due not just to expected losses but also to the risk of incurring costs that cannot be anticipated."

Second, although examples do exist, reducing the visibility of a tax increase intended to raise revenue from elites is rarely feasible. Elites, unlike average citizens, have the resources and the motivation needed to understand exactly how tax reforms affect their pocket books. Upper-income individuals and businesses are advised by accountants and tax specialists; business associations and large firms often have research departments to study and assess the impact of proposed reforms. As Hacker and Pierson (2005b: 37) point out: "F. Scott Fitzgerald was right: The very rich *are* different—not just in their preferences regarding tax policy but, crucially, in their level of knowledge with respect to various dimensions of this complex issue."

The imbalance in resources and information available to elites versus the majority of citizens creates an inherent asymmetry between the politics of increasing elite taxation on the one hand, and the politics of reducing elite taxation or increasing broad-based taxes on the other hand. Policymakers pursuing the latter objectives strive to reduce the *general public's* awareness of these reforms. There are numerous ways that tax cuts for elites, tax increases for the broader public, or reforms to roll back popular

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<sup>46</sup>I borrow the term obfuscation from Pierson (1994: 19-22), who elaborates a similar class of strategies to accomplish a different goal—retrenching welfare state benefits.

<sup>47</sup>Reducing taxpayers' awareness of the tax burden is a commonly discussed strategy in literature on welfare states and taxation (Wilensky 1975, 2002: 363-394; Steinmo 1993: 17, 195). Steinmo (1993: 17) observes that: "Public officials in all advanced democracies are ...under immense pressure to devise taxes that generate huge and growing amounts of revenue but that can be made acceptable to (or hidden from) the constituents who pay those taxes." Wilensky (2002: 391), meanwhile, asserts that: "it is not the *level* of taxes that creates tax-welfare backlash but the *type* of taxes—property taxes and income taxes with their visibility and perceived pain." However, these authors study societies with much more equitable income distributions and therefore focus on reducing the broader public's awareness of paying taxes—not economic elites' awareness of paying taxes.

<sup>48</sup>Note that visibility refers to characteristics of the tax, not to the salience of the reform in public debates or news coverage.

<sup>49</sup>Although sales taxes and other indirect taxes may not be included in the advertised price of the good, they also tend to be less visible than direct taxes. Their impact accumulates incrementally and taxpayers usually do not tally the cumulative total paid per year or per month.

benefits, can be designed to achieve that goal (Hacker and Pierson 2005b, Pierson 1994), and it may be relatively easy to manipulate mass perceptions of distributional consequences in other ways as well (Birney and Shapiro 2005).<sup>50</sup> In contrast, policymakers seeking to increase elite taxation face the far more difficult challenge of reducing *elites'* awareness of those reforms. The case studies I examine from include various examples of policy designs intended to lower the visibility of elite-taxing reforms, but only one was arguably effective.<sup>51</sup>

### ***Legitimizing Appeals***

Legitimizing appeals draw on widely held values or norms—vertical equity, horizontal equity, or nationalism—to circumvent instrumental power. When a tax reform is congruent with one or more of these values, it can be said to have *inherent legitimacy*—legitimacy arising from characteristics of the tax increase itself.

Legitimizing appeals attenuate instrumental power by making politicians with whom business enjoys favorable relationships less responsive to business regarding the reform proposal at hand. These strategies act by generating favorable public opinion that puts pressure on politicians (usually legislators), who might otherwise promote business interests, to accept reform. Legitimizing appeals are the executive branch's equivalent to strategies in which interest groups manipulate public opinion to “shape what Congress does” by framing issues in terms of particular symbols or principles (Birney and Shapiro 2005: 5). The logic of legitimating appeals is electoral: reform proponents can “make a credible threat to take the issue public in campaigns against politicians who did not support their bills,” (Birney and Shapiro 2005: 34).

In addition to attenuating business influence, legitimating appeals (particularly those based on vertical equity) can serve the potentially important purpose of consolidating support from politicians who tend to *favor* taxing elites. These strategies can be important for ensuring votes from within the governing coalition and/or for winning votes from members of the opposition, depending on the ideological positions or leanings of the parties represented in congress. Finally, legitimating appeals based on the principle of horizontal equity, discussed in more detail below, can not only attenuate business influence, but also reduce business opposition.

The effectiveness with which legitimating appeals attenuate business influence in congress is limited not only by the degree to which the executive can generate favorable public opinion by invoking the underlying norm, but also by the degree to which public opinion actually affects legislators' policy choices. This issue has been much discussed in the literature on American politics. Many scholars have identified problems with schools of thought that view policy outcomes as direct reflections of public opinion or the preferences of the median voter (Birney and Shapiro 2005). Legislators may not face punishment at the polls if they act against popular opinion for a number of reasons. For example, they may receive votes from citizens with cross-cutting preferences who approve of their performance on other issues (Roemer 1999). Similarly, strong partisan identity can motivate citizens to vote for a candidate even if his or her policy record does not entirely match voter preferences (Campbell et. al. 1960). Legislators may have especially wide leeway on issues that are perceived as low salience or of marginal importance to most voters (Geer 1996).

Hacker and Pierson (2005b) and Pierson (1994) present additional arguments for a potentially weak relationship between policy and public opinion based on Arnold's (1990) idea of causal chains. In order to punish politicians for enacting policies that go against voters' preferences, voters must be able to a) identify negative consequences, b) associate them with the policy enacted, and c) identify who is to

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<sup>50</sup>Note that the mechanism through which reducing visibility facilitates reform is different when the tax affects the mass public as opposed to economic elites. When the masses bear that tax burden, reducing visibility lowers anticipated costs to legislators of voting for the tax increase, because when voters are less aware of paying the tax, they will be less likely to punish politicians retrospectively at the polls. In contrast, as discussed above, reducing the visibility of tax increases on elites acts primarily by circumventing instrumental and structural power. Potential punishment at the polls is much less relevant when the aggrieved are a numerically small group of elites.

<sup>51</sup>See discussion of the tax on corporate interest payments in Argentina, Chapter 6, Part 1.

blame. Any weak point in this chain can free politicians from the constraints of public opinion. In the case of tax increases on elites, the first two steps in the causal chain may be particularly difficult to establish—these reforms usually do not *directly* benefit the broader population. Consequently, average voters may not be aware of the negative consequences of failed tax increases. I return to these points in the discussion of linking tax increases to benefits below.

Literature on Latin America provides evidence and additional arguments for a potentially weak relationship between policy outcomes and popular preferences. Luna (2005, 2010) finds that parties may win votes by delivering very different kinds of benefits to different constituencies. Upper-class sectors may vote for a party based on its economic policy positions, whereas lower-class sectors may vote for the same party on the basis of its ability to deliver constituency service in their districts. It follows that parties can win votes from the broader population whether or not their legislators reject higher taxation of elites.

Some institutional contexts may also mitigate the effects of public opinion on legislators' voting choices. Particular electoral systems may shield legislators from public opinion. Rules that make it easy for runner-up candidates to win seats in congress, such as Chile's binomial system, can make legislators less vulnerable to relatively small shifts in the electorate's opinion. In party-centered electoral systems, where career-based incentives dictate that legislators follow party leaders rather than cultivate personal reputations in their districts, Eaton (2002) finds that legislators are less responsive to interest groups pressures. This argument could be extended to public opinion pressures as well, although legitimating appeals can also convince party leaders to support reform.

Despite these caveats, cases examined in the following chapters demonstrate that legitimating appeals can in fact attenuate business influence. Even in political systems where legislators' policy positions are not particularly sensitive to popular opinion, legitimating appeals can serve the important purpose of countering attacks from the opposition claiming that reforms violate widely held norms of fairness or appropriateness.

The next three sub-sections define and discuss legitimating appeals based on three norms: vertical equity, horizontal equity, and nationalism.

### *Vertical Equity*

Vertical equity is the principle that taxpayers who earn more or own more assets should bear a larger share of the tax burden than those who earn or own less. Individual income taxes generally embrace this principle by imposing higher marginal tax rates on upper-income earners. In other words, vertical equity implies that taxation should be *progressive*. Appeals based on the norm of vertical equity are therefore a natural strategy choice when the proposed tax increase is progressive or popularly perceived as such.

Reforms that are highly *targeted* at elites are especially well-suited for vertical equity appeals. Targeting refers to how exclusively a tax increase affects upper-income sectors as opposed to middle or lower-income sectors. For example, increasing the top marginal income tax rate is more targeted at elites than reducing minimum allowances for all income tax payers. Likewise, imposing excise taxes on luxury goods consumed by the rich is more targeted at elites than raising the VAT rate, which affects consumers much more broadly.<sup>52</sup> While targeted tax increases are progressive by definition, not all progressive tax increases are highly targeted at elites.

The more targeted the tax increase, the more effective an appeal to vertical equity is likely to be. Because income is so concentrated in Latin America, even a reform that affects only the top ten percent of the population will likely include individuals who can be construed as belonging to the "middle class," usually professionals who are not manifestly "rich" according to prevailing cultural norms or by international comparison. Business leaders and politicians who defend the interests of upper-income sectors often seek to frame tax increases as affecting the "middle class" and/or the population much more

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<sup>52</sup>The VAT is more targeted at elites in practice when the informal sector is composed primarily of poor vendors and consumers (Cossio 2006).

broadly in order to legitimate their opposition. However, arguments that a tax increase hurts the “middle class” are harder to sustain the more elite-targeted the reform.

Of course, appeals to vertical equity can be made whether or not the reform’s impact is targeted at elites and/or progressive. In some cases, rhetoric alone may suffice to convince legislators or the public that a tax increase targets elites. However, appeals will be less vulnerable to counterarguments from the opposition, and hence more successful at generating public support if the design of the reform clearly embraces this principle.

Legitimizing strategies based on vertical equity appeals entail balancing several important tradeoffs. First, as a tax increase becomes more targeted, its revenue-raising potential decreases. Despite the fact that resources are highly concentrated in Latin America, the fiscal cost of increasing the degree of targeting can be consequential. Second, while a highly targeted reform can generate popular support, it can also provoke stronger opposition from business and upper-income individuals. Increasing the impact of the reform may be necessary to raise sufficient resources, and elites will accordingly oppose the reform more intensely. Further, although targeting and visibility do not necessarily co-vary (Figure 2.7), highly targeted taxes are often more visible, and as discussed previously, visibility tends to stimulate more intense opposition. When business strongly opposes a reform, it will more aggressively utilize its sources of instrumental power to influence the outcome, and more intense lobbying may counteract pressure on legislators from popular opinion. Third, highly targeted and visible tax increases single elites out as a class, which can stimulate elite cohesion by accentuating class-identity and activating class-cleavages.<sup>53</sup> Cohesion in turn can make lobbying more effective by legitimating business demands and strengthening business’s bargaining position.

Finally, it should be kept in mind that opposition strategies that entail reframing public debate in terms of issues or principles other than vertical equity may help business and elites more broadly cultivate public opinion in support of their own position against reform, even in highly unequal societies where the vast majority would be unaffected by the tax increase in question. Birney and Shapiro (2005:13-14) examine this phenomenon in the case of estate tax repeal in the US. They argue that repeal proponents were able to use public opinion to their own advantage by framing the estate tax as a “death tax,” connoting inappropriateness, or as unfair double-taxation, rather than a tax on extraordinary wealth.

**Figure 2.7: Elite Targeting and Visibility; Selected Tax Reforms**

		Visibility	
		High	Low
Elite Targeting	High	Most direct tax increases; Increasing top marginal income tax rates.	Eliminating caps on employers’ social security contributions.†
	Low	Lowering the minimum taxable income to broaden the income tax base; Thatcher’s poll tax, 1989-1992.††	Increasing the VAT.

†Employers’ social security contributions are often regressive due to ceilings that lower the burden on upper-income earners (Levy 2004: 5, 8; Hacker and Pierson 2004: 33). A reform in Argentina, for example, increased taxation of upper-income groups by raised these ceilings (Executive Decree 491, 2004).

††This tax consisted of a “painfully visible” uniform levy on all adults (Wilensky 2002: 382-4).

<sup>53</sup>This observation follows Lieberman (2003: 16). Targeted reforms may be more likely to stimulate intense elite opposition and/or cohesion where class distinctions are already quite evident, or where popular sectors have significant mobilizational capacity that threatens elites. See for example the discussion of the individual assets tax proposal in Bolivia, Chapter 7.

### *Horizontal Equity*

The principle of horizontal equity holds that taxpayers of similar economic means, regardless of the specific sources of their income, should bear a similar share of the tax burden. Tax policy choices that improve horizontal equity allow the executive to make this type of legitimating appeal. Eliminating exemptions often promotes horizontal equity. For example, the individual income tax base can be broadened to include all forms of income; some countries exempt particular kinds of capital income or tax them at reduced rates compared to wage income. In the realm of corporate taxation, special tax treatments that privilege particular sectors can be eliminated. Anti-evasion reforms also improve horizontal equity by ensuring that all taxpayers pay their due burden.

Because many reforms that enhance horizontal equity also enhance vertical equity, appeals to both principles can often be used simultaneously, or, in situations where vertical equity appeals might prove counterproductive by stimulating increased elite opposition or cohesion, horizontal equity appeals may be used to promote redistributive reforms instead (Ascher 1989: 419).<sup>54</sup> Anti-evasion measures are a prominent example of reforms that permit both vertical and horizontal equity appeals. Vertical equity appeals can focus on the importance of making sure the wealthy pay the taxes they owe. Middle or lower income sectors usually have little opportunity for income tax evasion since taxes are withheld directly from their wages, whereas upper-income sectors receive significant income from non-wage sources and can under-declare those earnings on tax returns. Horizontal equity appeals can simply point out that evasion is unfair to citizens of similar means who honestly pay their taxes. Eliminating exemptions for particular forms of income that accrue disproportionately to the wealthy also enhances both horizontal and vertical equity.

In addition to attenuating business influence by generating favorable popular opinion that pressures legislators to accept reform, horizontal equity appeals can reduce opposition from business and upper-income taxpayers. By definition, reforms that improve horizontal equity affect some sectors but not others and hence may avoid provoking widespread opposition. Moreover, appeals to horizontal equity are one of the few strategies that have the potential to generate *support* from business. As Ascher (1989: 465) observes: “Striving for horizontal equity (except between sectors) is the consensus point for tax reform because it seems ethically compelling, technically straightforward, and does not raise the issue of class conflict.” Horizontal equity-enhancing reforms vary in their potential for generating support from elites. Anti-evasion reforms tend to perform best on this criterion. This observation is particularly relevant in the case of corporate taxes, since law-abiding firms view tax evasion as creating unfair competition. Eliminating sectoral exemptions or special tax regimes can also generate support from sectors that did not enjoy the benefits, but this response is more likely where cohesion within the business community is weak. Where cohesion is strong, this class of reforms may elicit tacit or passive support at best. Moreover, eliminating special exemptions has the drawback that it can provoke particularly intense opposition from the affected sectors, which may see such reforms as attacking their core interests, as eluded to by Ascher in the quotation above.

### *Nationalism*

In the particular case of taxes on mineral resource extraction, legitimating appeals can be made on the basis of nationalism. Two features of these taxes lend themselves to these appeals: first, mineral resources are widely viewed as national patrimony, and second, firms mining these resources are often foreign or multinational. Many Latin American countries have well-known histories of exploitation by foreign powers and/or companies that sought to appropriate the regions’ mineral riches, often in collaboration with national elites (Galeano 1973, Malloy 1977). Nationalization of mineral resources was extremely popular across groups with very different ideological orientations. In Chile, for example, Congress voted unanimously in favor of copper nationalization in 1971. Historical experiences of exploitation can be evoked to mobilize nationalistic enthusiasm for increasing taxes on mineral resources.

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<sup>54</sup>As Ascher (1989: 419) observes: “greater horizontal equity, a virtually consensual objective, can serve as the explicit objective of tax reforms that also have a vertically redistributive impact.”



Proponents of such reforms need only assert that foreign companies are stealing the wealth of the nations' citizens.

Appeals based on nationalism are potentially the most effective legitimating appeals in terms of arousing popular support. The targets of these taxes, which are often a small number of foreign or multinational firms, may be more easily identifiable as a distinct group and more easily portrayed as wrong-doing or exploitative than national economic elites.

Moreover, to the extent that mineral resource taxes affect primarily foreign or multinational companies, they do not directly threaten local elites, and may therefore provoke less opposition from domestic business than other tax increases. However, the stronger the economic, organizational, or informal linkages between foreign firms in the extractive resources sectors and local elites, the more the latter will oppose these taxes.<sup>55</sup>

Nationalistic appeals can also be used to arouse public support for increasing taxation of multinational and foreign firms operating in other areas of the economy. However, the history of mineral resource exploitation and dependency may help to generate more intense popular support in favor of taxing mineral resource extraction.

### **Benefit-Side Strategies**

Benefit-side strategies aim to shift attention away from the tax increase and the immediate costs it imposes on elites. These strategies include compensation, emphasizing stability, and linking to social spending. These strategies can be distinguished according to who receives the benefits (Figure 2.8). Compensation entails granting benefits to those who will bear the tax increase. Emphasizing stabilization involves a universal benefit for elites and society as a whole. Linking taxation to social spending, in contrast, involves popular benefits that usually are not directly shared by elites, given that social programs in Latin America are often means-tested and that elites tend to use private rather than public services (for example, education and health care). The mechanisms through which these strategies act differ accordingly. Compensation and emphasizing stabilization reduce opposition from business, whereas linking to social spending attenuates business influence by generating popular support, which pressures legislators who might otherwise promote business interests to approve reform.

**Figure 2.8: Benefit-Side Strategies**

Strategy	Benefit Recipient		Mechanism
	Business or Upper-Income Individuals	Popular Sectors	
<b>Compensation</b>	Yes	No	Reduces Business Opposition Reduces Concern Over Investment
<b>Emphasizing Stabilization</b>	Yes	Yes	Reduces Business Opposition
<b>Linking to Social Spending</b>	Rarely	Yes	Attenuates Business Influence

### ***Compensation***

Compensations to reduce business opposition may take the form of anything from direct payoffs to reforms business favors in other policy areas. They can be selective and particularistic, benefiting some sectors but not others, or they can be more inclusive. The type and scope of benefits offered may depend

<sup>55</sup>These issues are discussed with respect to taxes on copper extraction in Chile in Chapter 4 (Part 3) and taxes on hydrocarbons companies in Bolivia in Chapter 7.

on the level of business cohesion and the relative power of different sectors. If business is highly cohesive, compensations may need to reach all affected sectors. If business is not cohesive, compensations for the most powerful sector or sectors may suffice. Compensations can either be negotiated informally outside the framework of the tax reform package, or they may be explicitly included within the proposed legislation.

Literature on business and market reforms in Latin America suggests that compensations can be quite effective for reducing business opposition. Etchemendy (2001, 2004) shows that payoffs distributed to powerful business sectors in Argentina helped to advance market reforms in the 1990s. For example, protected national industries in the steel and petroleum sectors were given rents in new markets to generate support for privatization and deregulation. Similarly, Corrales (1998) argues that strong inducements were critical for overcoming resistance from powerful conglomerates to privatization in Argentina. Kingstone's (2001: 1003-4) concept of "policy bundling" can be viewed as another type of compensation, in which simultaneous or closely sequenced reforms that business supports can reduce resistance to reforms that might stimulate opposition if introduced in isolation from a broader reform agenda. Kingstone argues that policy bundling helped reduce opposition from the private sector to trade liberalization in Brazil. Likewise, Conaghan and Malloy (1994) argue that support for the neoliberal project in the mid-1980s in Bolivia mitigated business opposition to any one reform in particular, including the increased tax burden associated with first-generation tax reforms.

In addition to reducing business opposition, compensations can be designed to reduce concerns that a tax increase could provoke disinvestment. If a tax increase is accompanied by or linked to other measures that are clearly pro-investment or pro-growth, potential negative effects of the tax increase may be mitigated.<sup>56</sup>

Compensation strategies have several limitations. First, they can entail significant fiscal costs that may not be feasible when the government is in need of revenue. Second, if compensations are negotiated outside the framework of a formal reform package, business must view the executive's offer as credible and the administration as capable of delivering the benefits. If the compensation in question requires congressional approval—for example, a reform in another policy area—the executive must be strong with respect to the legislature. That is, governing party or coalition discipline must be high and the opposition must not have sufficient representation or motivation to block the measure.

### ***Emphasizing Stabilization***

This strategy aims to reduce opposition to tax increases by emphasizing a shared/universal benefit—stabilization—and convincing elites that the alternative—fiscal, economic, or even sociopolitical instability—is more costly than shouldering the tax burden. That economic crisis and/or a threat of socio-political instability makes elites more willing to accept costs associated with increased taxation or economic reforms more generally is a common observation in literature on structural adjustment in Latin America. For example, hyperinflationary episodes imposed severe costs and predisposed business and other actors to accept or support reform (Acuña 1994, Conaghan and Malloy 1994, Weyland 2002). In addition to reducing business opposition to reform, emphasizing stabilization in some cases may serve to reduce concerns over disinvestment by building investor confidence.<sup>57</sup>

Emphasizing stabilization does not require a particular reform design or choice of tax instrument. However, in times of crisis when emphasizing stabilization is a logical strategy, taxes that are easy to design, implement, and administer and that raise revenue quickly are most likely to be proposed. In practice, anti-evasion measures that do not bear immediate results will not be paired with a strategy emphasizing stabilization.

A number of logical conditions must hold in order for emphasizing stabilization to succeed. First, elites must perceive that instability is in fact likely or imminent at the time the executive proposes a tax increase. A recent history of economic crises or hyperinflation may increase elites' receptiveness to

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<sup>56</sup>For an example of this approach in Chile, see Chapter 4, Part 5.

<sup>57</sup>See discussion of Argentina's 2001 financial transaction tax, Chapter 6, Part 1.

warnings that economic instability will ensue if fiscal discipline is not achieved. Second, elites must perceive that instability will be highly costly. This may be the case if fiscal indiscipline threatens to undermine continuation of an economic model, or the continuation in power of a government that favors elites. If elites do not feel vulnerable to instability, however, they have little reason to accept a tax increase. Elites might have options that allow them to minimize the costs of economic instability, such as placing assets off shore to protect their value. Likewise, certain business sectors may be less vulnerable to economic instability because of the nature of their assets. Third, elites must perceive that fiscal discipline will have a stabilizing influence, and that there is no way to achieve fiscal discipline other than by increasing taxes. That is, privatization of assets, austerity, reducing state corruption, reallocation of funds, foreign loans, or international aid must not be perceived as viable options in the short term.

Because stability provides a diffuse benefit for elites, whereas the costs of taxation tend to be concentrated, visible, and more immediate, approaches that focus on collective-action problems suggests that emphasizing stabilization will be more likely to succeed when elites are cohesive rather than fragmented. Weyland (1997), for example, argues that individual sectors will mobilize to defend their narrow, short-term interests in low taxation unless an economy-wide association can coordinate business around shared long-term interests. Similarly, Lieberman (2003) argues that elites must be cohesive if they are to agree to higher levels of taxation. However, I find that an encompassing association or cohesion more generally is not necessary to induce business support or acceptance of increased taxation, as long as the conditions discussed above hold, in particular, that the threat and cost of instability be perceived as high and immediate.

### ***Linking to Social Spending***

By emphasizing either widespread or targeted benefits financed by the tax increase, linking to social spending can generate popular support that pressures politicians to vote for the reform. Widespread benefits may be popular with the majority of voters, while benefits targeted to low-income groups may generate broad support on the basis of norms such as equity or morality. The logic of linking to social spending is similar to that of tax-side legitimacy appeals. Whereas the latter strategy entails appeals to the inherent legitimacy of the tax increase itself, linking to social spending entails appeals to *derivative legitimacy*—legitimacy derived from the benefits the tax increase will fund. Linking to social spending allows the executive to blame legislators who vote against reform for blocking popular benefits. In addition, linking to social spending can create potential political payoffs for legislators who support reform by allowing them to share credit for popular programs.<sup>58</sup>

In addition to creating popular pressure on legislators to approve reform, in rare cases, linking to social spending can reduce opposition from elites, who tend not to receive direct benefits from social spending. When social or political instability is high and/or demands for redistribution are strong, business and elites more broadly may be willing to accept higher social spending financed through increased taxation in order to promote stability (Boylan 1996).<sup>59</sup> In such cases, linking to social spending becomes analogous to emphasizing stabilization. Linking to spending may also reduce opposition from elites by legitimating the tax reform in the eyes of the public and therefore making it more costly for elites to openly resist the reform.

Linking to social spending can be achieved through discourse and/or through reform design. Discourse alone creates the weakest links to popular benefits. Three techniques can be used to make links to social spending stronger and more apparent to legislators and the public. First, social spending and tax increases can be included in the same reform package so that they are debated simultaneously. This reform design gives greater credibility to the executive's assertions that the tax increase will be used to fund popular benefits. Second, in some institutional contexts, spending measures included in the reform

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<sup>58</sup>Linking to social spending is a strategy identified in literature on welfare states (Steinmo 1993: 17). However, in the context of more equitable income distributions and more universal social programs, where the majority of citizens both pay taxes and receive benefits, the political dynamics are different.

<sup>59</sup>See discussion of Chile's 1990 tax reform in Chapter 3.

package can be made contingent on approval of the tax increase. In other words, a reform can be designed such that rejection of the tax increase automatically precludes spending measures from taking effect.<sup>60</sup> Third, revenue from tax increases can be formally earmarked for certain spending programs, that is, the legislation can specify the exact purpose for which the revenue is to be used. The last two designs are most effective for blaming opposition legislators for blocking popular benefits should they vote against the tax increase.

The potential for linking to spending to mobilize popular support depends on features of the associated spending program. For example, the more visible, easily understood, immediate, and broad-based the benefits, the more support they are likely to elicit and the greater the pressure legislators are likely to feel to approve the tax increase. Popular support may also depend on whether or not citizens perceive that the state has the necessary administrative capacity and the probity or incentives needed to implement social programs and ensure that the benefits reach their intended recipients.

Linking to social spending enjoys advantages over several of the strategies discussed previously. By focusing debate on provision of popular benefits, linking to spending may raise the political stakes for legislators more effectively than tax-side appeals to legitimacy. Social spending is likely to draw greater attention and to be perceived as a more important issue by the public at large than tax reforms that affect primarily elites. Further, linking to spending through reform design in association with a well-devised communication strategy can solidify each of the steps in Arnold's causal chain, by raising the public's awareness of the negative consequences of failed tax reform, encouraging the public to associate those negative consequences with the failed reform, and helping the public identify which politicians are to blame.

As with other strategies, linking to spending has various limitations and drawbacks. Most importantly, like tax-side legitimating appeals, the effectiveness of linking to social spending will be limited by the wide range of factors previously discussed that can make politicians' policy positions less responsive to public opinion. An obvious additional limitation is that linking to spending would not be appropriate when revenue is needed for purposes other than expanding social programs. Earmarking has the additional drawback that it creates budgetary rigidities; it restricts how funds can be spent in the future. Earmarking may be undesirable from a political perspective because it limits the potential for discretionary spending.

Finally, Ascher (1989: 446) makes note of a key tradeoff inherent in linking tax increases to redistributive social spending: "The cost of this tactic is that by making explicit connections between specific taxes and specific expenditures, the directly redistributive nature of taxation becomes all the more obvious." Just as elites may oppose more visible taxes more intensely, they may more intensely oppose reform packages transparently designed to allocate their resources for the benefit of other groups. This problem has also been noted in literature on welfare states.<sup>61</sup> In sum, linking to progressive social spending, like vertical equity appeals, can generate support on the side of popular opinion, but by making redistribution more visible, it may generate more opposition from elites. Which factor prevails—popular support versus elite resistance—will depend on the strength and sources of business power, reform timing, and the broader context in which the tax increase is proposed.

### **Dividing and Conquering**

As Pierson (1994: 22) observes, "'Divide and conquer' is an obvious political ploy, but that need not render it any less effective." Dividing and conquering may combine elements of both tax-side and benefit-side strategies to reduce business opposition and undermine or preclude formation of a united front against reform.

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<sup>60</sup>This technique has been used in Chile where the executive enjoys exclusive initiative on tax policy. See Chapter 4, Parts 2, 5.

<sup>61</sup>For example, Wilensky (2002: 392) makes the related (but distinct) point that "Less visible taxes and more universalistic spending make it possible to finance a generous welfare state whose benefits are substantial and widespread." He focuses however on the tendency of the "middle mass" rather than elites toward backlash against means-tested social spending and visible tax increases.

On the benefit side, the executive may be able to offer selective compensations in exchange for acquiescence from particular sectors. This approach is likely to be more effective when business cohesion is low—that is, when there is no effective economy-wide business organization, shared ideology or common business identity that could facilitate collective action—such that it is less costly to encourage any given sector to defect from a common opposition front.<sup>62</sup>

On the tax side, the executive can simply design a tax increase to affect some groups or sectors but not others, in order to avoid provoking a united opposition front. This approach will also be most effective when business cohesion is low. If business is highly cohesive, taxing any particular sector may still elicit opposition from the broader whole.

Another tax-side division strategy entails designing a tax increase to exploit cleavages within the business sector (or among elites more broadly). By cleavage, I mean a division that involves competing interests and potential rivalries or antagonisms. This approach may solicit support from the rival sectors or groups that are not targeted by the reform. For example, anti-evasion reforms exploit a cleavage between the formal sector and the informal sector, or more generally between firms that comply with tax laws and those that do not. As previously discussed, the formal sector and/or firms that comply with tax laws are often openly antagonistic toward the informal sector and tax evaders, which are seen as engaging in unfair competition. Anti-evasion reforms therefore have the potential to draw support from within the formal sector. It may also be possible to exploit regional divisions within the business sector. Certain economic activities may be concentrated in regions that have historical rivalries with other regions. Taxing region-specific sectors may elicit support from business in rival regions. It is important to note that cleavage-exploiting strategies for dividing and conquering are often closely related to appeals to horizontal equity, as is the case with anti-evasion reforms. Exploiting cleavages will be most applicable when the business sector is less cohesive. If the business sector is heterogeneous, cleavages involving competing interests among groups or sectors may be more common.

### **Overview of Reform Strategies**

Figure 2.9 summarizes the strategies discussed in this chapter, the mechanisms through which they facilitate tax increases, the tax policy choices or reform techniques with which they tend to be associated, and their primary limitations or drawbacks. This typology accounts for all of the major strategies used by governments in Chile, Argentina, and Bolivia to legislate tax increases in the aftermath of structural reforms. The strategies certainly were not successful in all cases; however, each proved important for reform on at least one occasion, as the following chapters will illustrate. These strategies have been particularly important in the case of Chile, where business has enjoyed very strong instrumental power since the 1990 transition to democracy (Chapter 4).

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<sup>62</sup>See discussion of Argentina's 1998 tax reform, Chapter 5.

**Figure 2.9: Overview of Reform Strategies**

<b>REFORM STRATEGIES</b>		<b>MEANS of CIRCUMVENTING BUSINESS POWER</b>	<b>POLICY CHOICE or TECHNIQUE</b>	<b>POTENTIAL DRAWBACKS or LIMITATIONS</b>
<b>TAX SIDE</b>	<b>Attenuating Impact</b>	Reduces Business Opposition, Reduces Concerns Over Disinvestment	1. Incremental Reform 2. Phase-Ins 3. Temporary Tax Increases 4. Diffusion Across Sectors	1-3. Fiscal Cost  4. Antagonizing Multiple Sectors
	<b>Obfuscating Incidence</b>	Reduces Business Opposition, Reduces Concerns Over Disinvestment	Reducing Visibility	Inherently Difficult
	<b>Legitimizing Appeals</b> 1. Vertical Equity 2. Horizontal Equity 3. Nationalism	Attenuates Business Influence  2. Reduces Opposition	1. Elite-Targeted Taxes  2. Anti-Evasion Reforms, Eliminating Exemptions 3. Taxing Extractive Industries	Politicians May Not Respond to Popular Opinion 1. Fiscal Cost, May Provoke Strong Business Opposition
<b>BENEFIT SIDE</b>	<b>Compensation</b>	Reduces Business Opposition, Reduces Concerns Over Disinvestment	1. Including in Reform Package 2. Negotiating Separately	1-2. Fiscal Cost 2. Requires Credible Executive Commitment to Deliver Benefits
	<b>Emphasizing Stabilization</b>	Reduces Business Opposition	Taxes that Raise Revenue Quickly	Most Relevant During Fiscal Crisis
	<b>Linking to Social Spending</b>	Attenuates Business Influence	1. Inclusion in Reform Package, 2. Benefits Contingent on Tax Increase, 3. Earmarking	Politicians May Not Respond to Popular Opinion, May Provoke Strong Business / Elite Opposition 3. Budgetary Rigidities

### **Alternative Explanations**

The previous sections of the chapter have developed a framework for explaining the nature of the tax reform agenda and the fate of reform proposals that emphasizes the importance of business power. Literature on tax reform in Latin America, taxation and international pressures, and business politics more broadly provides a range of explanations for various aspects of tax policy that either treat facets of business power in ways that differ from my framework, or emphasize explanatory factors other than business power. In the following sections, I review and evaluate hypotheses from this literature that are relevant to the cases I examine. While I do incorporate elements from some of these explanations into my framework, these arguments predict incorrect outcomes, fail to account for the full range of variation observed across my cases, or address limited aspects of the phenomena I seek to explain.

### **Business Power**

Various alternative explanations draw on aspects of business power. This section begins by considering a rival hypothesis regarding elite cohesion. Whereas I treat cohesion as a source of instrumental power that can help business resist taxation, some authors maintain that cohesion is irrelevant for business influence, or that cohesion in fact leads to higher taxation of elites. These rival hypotheses predict incorrect outcomes in the cases examined in this study. Next, I review the well-known structural power argument that competition for mobile international capital leads to reduced corporate taxation. I maintain that although capital mobility can be an important component of structural power, international capital mobility alone cannot explain outcomes observed in my cases. Finally, I consider a third form of business power advocated by some analysts—discursive power—which I argue provides no additional analytical leverage beyond instrumental and structural power.

### ***Rival Instrumental Power Hypothesis: Cohesion Facilitates Elite Taxation***

Several recent studies present rival hypotheses regarding business cohesion and policy influence. Weyland (1997) and Lieberman (2003) maintain that elite cohesion *facilitates* progressive taxation and equity-enhancing reforms more broadly. Drawing on Olson, Weyland (1997) argues that fragmentation discourages business from coordinating around shared, long-term interests in fiscal stability. Each sector instead resists tax increases. In contrast, encompassing associations facilitate tax increases by streamlining bargaining and making agreements enforceable, as argued in literature on corporatism (Schmitter and Lehbruch 1979, Hall and Soskice 2001). Likewise, Lieberman (2003) argues that when elites are divided, each sub-group opposes taxation, perceiving that the benefits accrue to others at its own expense. But when elites share a common identity that promotes class cohesion, they can agree to pay higher taxes. Further, “the state executive will find it much easier to provide bargains and credible commitments that will actually appeal to those upper-group interests than if there is significant political fragmentation,” (Lieberman (2003: 16). In the American politics literature, Smith (2000: 8) maintains that cohesion does not enhance business influence. In the US, he argues, issues that unite business are highly salient for voters, so politicians respond to their constituencies, not business interests, on these issues.

These arguments predict incorrect outcomes in Argentina and Chile. Corporate taxes increased significantly in Argentina, where business is sectorally divided, whereas corporate tax increases were marginal in Chile, where there is a strong economy-wide business association and business tends to be highly united on economic policy.

The scope of Smith’s US-derived argument is limited for several reasons. First, as discussed earlier in this chapter, many factors can free politicians from concern regarding punishment at the polls for their policy positions. In Chile, for example, the structure of electoral competition is such that legislators can win votes from the popular sectors on the basis of small-scale, district-level clientelism, rather than policy positions (Luna 2006, 2010). Consequently, politicians do not necessarily face electoral punishment if they side with business and oppose popular tax reforms. For example, right-party legislators in Chile voted against a copper royalty that enjoyed 67% popular approval and 60% to 80% support among their own intended voters (CERC 2004, see Chapter 4, Part 3). Second, tax increases targeted at elites are not

necessarily salient electoral issues for the popular sectors in Latin America. Reformers have often needed to craft strategies, formulate arguments, and disseminate information regarding the benefits associated with such tax increases in order to build popular support.

Weyland and Lieberman’s arguments, meanwhile, are of limited explanatory power because tax preferences cannot be predicted from business organization or elite cohesion alone. In some cases, elites may indeed have incentives to support redistribution and accept higher levels of taxation. For example, elites may support limited redistribution to promote political stabilization or to prevent regime change.<sup>63</sup> But examining levels of elite cohesion alone provides little information about whether or not elites have incentives to support redistribution. Many factors affect business’s preferences and strategic calculations. And if business opposes a reform, cohesion strengthens its ability to resist.

Weyland and Lieberman’s conclusion that elite cohesion facilitates elite taxation appears to be driven partly by their choice of cases (Figure 2.10). Both authors examine one case in which fragmented elites resisted redistribution—Brazil—and one case in which cohesive elites had incentives to support redistribution—South Africa under apartheid (Lieberman 2003) or Chile immediately following the 1990 transition to democracy (Weyland 1997). In South Africa, white elites were motivated to pay higher taxes in order to fund a state that they controlled and that directly served their interests. Higher taxation contributed to the stability of the regime by financing the elimination of white poverty and therefore undermining the potential for class-based solidarity with the excluded black majority (Lieberman 2003). Likewise, in Chile in 1990, business accepted a corporate tax increase based on the strategic calculation that the social spending it would finance would help legitimize the dictatorship’s neoliberal model, popularly viewed as benefiting only the rich (Chapter 3). However, neither Weyland nor Lieberman examine cases in which cohesive elites rejected redistribution, such as Chile after 1990. Therefore, they are unable to identify elite cohesion as a source of instrumental power, and their argument regarding the causal effect of cohesion on equity-enhancing reform cannot be generalized.

**Figure 2.10: Elite Cohesion vs. Fragmentation and Tax Policy Outcomes**

	Taxation of Elites	
	Lower and/or Marginal Increases	Higher and/or Substantial Increases
<b>Cohesion</b>	Chile post-1990 (this study)	Chile 1990 (Weyland 1997) South Africa (Lieberman 2003)
<b>Fragmentation</b>	Brazil (Weyland 1996, 1997) (Lieberman 2003)	Argentina (this study)

As for fragmentation, other factors appear to do more of the causal work in Weyland’s (1996) analysis of Brazil, where little progress was made toward increasing taxation of elites during the period he examines. First, Weyland’s process-tracing narrative illustrates that what I term informal ties to decision-makers—a source of instrumental power—helped business interests defeat initiatives to eliminate particularistic tax benefits and exemptions. Weyland (1996: 51, 59) maintains that in Brazil, business fragmentation created incentives for business to develop informal ties with decision-makers (eg, to “penetrate the state apparatus”), and accordingly, his theoretical discussions tend to subsume the causal effects of informal ties under the consequences of business fragmentation.<sup>64</sup> This approach is problematic

<sup>63</sup>Acemoglu and Robinson (2006) explore this possibility through formal models.

<sup>64</sup>See for example Weyland (1996: 184-5).



because business fragmentation does not necessarily coincide with strong informal ties to decision-makers elsewhere in Latin America; Argentina serves as a case in point.<sup>65</sup>

Second, fragmentation of state authority contributed significantly to the failure of progressive tax reform initiatives in Brazil: “Competing state agencies have often blocked reform measures in conflicts within the executive branch, subverted them by lobbying in congress, or corroded their implementation by wrangling over bureaucratic turf,” (Weyland 1997: 59). In this context, Weyland identifies a dynamic whereby fragmented business interests conquered a divided executive branch by seeking protection from captured agencies and by exploiting bureaucratic rivalries. As with informal ties to decision-makers, Weyland (1996: 51, 59) argues that business fragmentation contributed to fragmentation of state authority in Brazil. But again, business fragmentation need not imply that state authority is also fragmented. Where business is fragmented but state authority on economic policy is concentrated within a single ministry, as in Argentina, a different dynamic from that described by Weyland may arise, in which a cohesive executive branch conquers divided business interests (Chapter 5).

### ***Structural Power Hypothesis: Capital Mobility Leads to Reduced Taxation***

A significant body of research on OECD countries has explored the idea of international tax competition driven by capital mobility. Many authors have argued that increased international capital mobility in the era of globalization augments structural power and forces governments to reduce corporate tax rates in order to attract and retain investment; otherwise, mobile capital will relocate to jurisdictions with lower taxes and hence higher net returns (McKenzie and Lee 1991; Rodrik 1997, Williams and Collins 1997, Appel 2006). Similarly, Swank (2006) argues that efficiency-oriented reforms in the US, especially corporate tax cuts in the 1980s, influenced tax policy in developed democracies through a diffusion process driven by concern over competition for mobile assets.<sup>66</sup> Although other studies find that governments have retained leeway to craft tax policy (Swank 1998, Inclán et al. 2001, Gelleny and McCoy 2001, Basinger and Hallerberg 2004),<sup>67</sup> the hypothesis that increased capital mobility imposes significant constraints on domestic policymaking is prominent in literature on globalization.

The tax competition argument, however, proves unsatisfactory for explaining corporate tax outcomes in the countries I examine. Both Chile and Argentina were highly integrated into international markets (Morley et al 1999) and actively sought to attract foreign investment in a context of high international capital mobility in the 1990s. Argentina was especially dependent on capital inflows in the context of Convertibility, which pegged the peso to the dollar. Contrary to the international tax competition prediction, however, Argentine governments increased corporate taxation significantly. By 1999, Argentina’s corporate tax rate was the highest in the region, and the country collected more corporate tax revenue as a proportion of GDP than did Chile,<sup>68</sup> despite the fact that capital mobility as measured by capital account and financial liberalization was higher in Argentina than in Chile in the 1990s. Whereas Argentina’s capital account was the second most liberalized in Latin America by the early 1990s, Chile’s capital account remained more regulated than average until after 1998 (Morley et al 1999: 27, Lledo, Schneider and Moore 2004: 53-4). Furthermore, although corporate tax policy in Chile was essentially consistent with the tax competition hypothesis prediction—corporate taxation remained low despite a small rate increase in 2001—interviews with high-level policymakers reveal that capital mobility and structural power played at most a very secondary role in producing this outcome (Chapter 3).

The international tax competition hypothesis fails to explain tax policy outcomes in these two countries because capital mobility is not necessarily an indicator of structural power. As discussed earlier in this chapter, structural power arises from an anticipated disinvestment threat, which requires that investors have incentives, not just the ability, to relocate their capital. Moreover, decision-makers must

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<sup>65</sup>Some sectors did have informal ties under particular administrations, but many others did not.

<sup>66</sup>Simmons and Elkins (2004) apply a similar diffusion argument based on the mechanism of “competition” to explain liberalization of capital accounts, current accounts, and exchange rates.

<sup>67</sup>Wibbels and Arce (2003) find mixed results in their analysis of Latin America.

<sup>68</sup>Argentina’s corporate tax revenue fell below Chile’s for a few years due to the 2001 crisis but again surpassed Chile’s after 2003.

anticipate disinvestment in order for structural power to influence policy. The tax competition hypothesis takes into account neither policymakers' perceptions nor cross-national variation in the disinvestment incentives that tax increases create. Capitalists will relocate only if a reform significantly reduces profits relative to alternative investment options. Taxes are one of many policies affecting profits, and favorable policies in other areas may offset the costs of higher taxation (Hacker and Pierson 2000: 282, Gelleny and McCoy 2001: 510). For example, Gelleny and McCoy (2001: 521) find that favorable education policy that creates a skilled and productive workforce significantly alters the observed relationship between capital mobility and corporate taxation in OECD countries: "As education levels are increased, the [negative] effect on taxes of removing barriers [to capital mobility] is decreased until there is actually a positive relationship between capital mobility and corporate taxes."

### ***Discursive Power***

In recent years, some scholars have invoked the concept of "discursive power" to understand business influence in the realm of global governance. Fuchs (2007: 139) defines discursive power as business's ability to exert influence "through the shaping of norms and ideas;" likewise, Newell (2009: 52) writes: "This power derives from and expresses itself in the ability to construct and reinforce dominant framings of issues." Fuchs (2007: 61) elaborates that discursive power plays a role in "constituting and framing policies, actors, and broader societal norms and ideas." This definition relates centrally to the "third dimension" of power as conceptualized by Lukes (1974: 23), whereby "*A* may exercise power over *B* ...by influencing, shaping, or determining his very wants."<sup>69</sup> While this third dimension of power is a well-established concept, I argue that the ideas Fuchs expounds in her discussion of discursive power are already incorporated within my treatment of instrumental power and strategies, such that her additional concept adds no analytical leverage.

To the degree that shaping norms and ideas entails deliberate actions on the part of business actors, discursive power is no different from instrumental power. In fact, early instrumentalists like Mills (1956: 314-5) and Miliband (1969: 182, 211) discuss similar ideas about power as those expounded by Lukes. For example, while Lukes (23) emphasizes that an actor can "secure ...compliance by controlling ...thoughts and desires," Miliband (1969: 211) discusses "the effort business makes to persuade society not merely to accept the policies it advocates but also the ethos, the values and the goals which are its own." Three sources of instrumental power—media access, technical expertise, and informal ties to policymakers—are relevant for the socialization and indoctrination processes these authors discuss. Preferential media access (or control of the mass media, as discussed by all three authors<sup>70</sup>) may allow business to define and disseminate norms. Technical credentials and informal ties to policymakers may play a role in socializing decision-makers into a particular school of economic thought and/or convincing them that certain policies are technically appropriate or inappropriate. While Fuchs identifies a seemingly distinct source of discursive power—legitimacy or authority—these attributes can also be related to sources of instrumental power. Technical expertise, preferential media access, and even cohesion can establish business as a legitimate, authoritative actor in policy debates with legitimate positions and demands. Legitimacy or authority may be related to relationship-based as well as resource-based sources of instrumental power. Policymakers who have informal ties to business, or who are prominent business-people themselves, may be more likely to view business representatives as legitimate actors. And institutionalized government-business consultation clearly makes business a legitimate actor in policymaking.

In addition to shaping norms and ideas, Fuchs (2007: 60-61) discusses business's ability to exert influence by drawing on existing norms and ideas: "The present analysis clearly focuses on the power that can be exercised through discourse... Actors strategically use discourse ... by employing symbols and story-lines and by strategically linking issues and actors to established norms and ideas." Several of the

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<sup>69</sup>In addition, Newell (2009) relates discursive power to the work of Antonio Gramsci.

<sup>70</sup>Lukes (1974: 23), Mills (1956: 314-5) and Miliband (1969: 182, 227-229). Business access to media also plays a key role in Newell's (2009) discussion of discursive power.

strategies discussed earlier in this chapter—legitimizing appeals, linking to spending, and to some extent emphasizing stabilization—entail precisely what Fuchs describes. Just as the government can use legitimizing appeals or linking to spending to promote reform, business can craft legitimizing appeals or forge links to other issues to oppose reform. For example, if the government frames a tax increase on upper-income individuals as promoting vertical equity, a broadly accepted norm, business may frame the tax increase as a disincentive for hard work, which violates another widely held value. Accordingly, there is no need to define a distinct type of power to include such strategies in our analysis. Moreover, the success of legitimizing appeals employed by business (or by the government) depends to a large extent on business's sources of instrumental power. The sources of instrumental power discussed above can clearly lend greater weight and credibility to business arguments and hence may make business's framing strategies more effective.

Finally, whether or not one introduces the concept of discursive power, assessing business influence over policymakers' *a priori* views of what reforms are technically appropriate and desirable, per the third dimension of power, poses challenging problems. Simply establishing that policymakers hold views on economic policy that coincide with those espoused and promoted by business does not necessarily provide evidence of business influence. One would need to investigate the educational backgrounds that shaped policymakers' technical views, as well as the extent to which the academic institutions they attended taught particular schools of thought as a result of deliberate business initiatives or diffusion of norms from the private sector, keeping in mind that the causal arrow could flow either from the academy to the business community or vice-versa.<sup>71</sup> Such endeavors would constitute a challenging research agenda in their own right. I explore instead what I judge to be a more salient research question from the point of view of assessing prospects for redistribution: how policymakers identify feasible options from among the set of reforms they view as technically appropriate and desirable, and how business influences decisions made at that particular stage of agenda formulation.

### **Non-Business Actors**

Societal actors other than business can also influence tax policy. Labor unions and/or other organized popular sectors, like informal-sector workers' associations in Argentina or indigenous movements in Bolivia, are examples of such actors. Like business, these actors may enjoy favorable relationships with policymakers. Cases exist in which these sectors developed informal ties with policymakers, were offered cabinet positions or incorporated onto party tickets (recruitment),<sup>72</sup> served as important or even core constituencies for labor-based, indigenous, and/or left parties (partisan linkages), or participated in institutionalized consultation with the executive branch.<sup>73</sup> Further, these actors may be able to mount collective action outside of formal policymaking arenas to lend force to their demands.<sup>74</sup>

These non-business actors may influence tax policy in a variety of ways. Labor and other popular sector actors may demand higher taxation of economic elites in accord with redistributive political agendas. Or these actors may simply resist regressive tax increases affecting their own members that could otherwise serve as alternatives to reforms that target economic elites. Where labor and/or popular sectors are strong, broad-based or regressive tax increases may be politically infeasible, just as elite-targeted tax increases may be infeasible where business power is strong. Labor and/or popular sector strength may therefore influence the tax agenda, by encouraging policymakers to propose elite-targeted reforms, as well as the outcome of reform proposals. Finally, these actors may have a more indirect influence on tax policy by generating revenue needs. Addressing labor and/or popular sector demands often requires increased spending, which may in turn necessitate tax increases.

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<sup>71</sup>For example, Valdes (1995) describes the process through which economists from the University of Chicago, in collaboration with a small groups of like-minded Chilean economists, introduced radical free-market principles in Chile. These principles eventually became dominant among business in Chile, despite the fact that much of business at the time favored state protections incompatible with the new economic views.

<sup>72</sup>For examples of the foregoing two relationships in Argentina, see Garay (2007).

<sup>73</sup>Institutionalized consultation with labor, for example, has been a component of tripartite bargaining in Europe.

<sup>74</sup>See Scartascini and Tommasi 2010 for a discussion of when actors are likely to undertake protest.

A focus on non-business actors suggests an alternative explanation for Argentina's greater progress compared to Chile at increasing tax revenue in the aggregate and in specific policy areas such as corporate taxation: that these differences are due to the greater strength of labor and other popular sector groups in Argentina. Whereas labor unions in Chile were hard-hit by economic restructuring and repression under the dictatorship, labor unions in Argentina enjoyed a resurgence after 2000.<sup>75</sup> In addition, whereas popular sectors remained largely unorganized and demobilized in Chile following the transition to democracy, unemployed workers in Argentina organized in the late 1990s and mounted sustained and massive demonstrations from 2000 to 2003 (Garay 2007). One might anticipate that any of the mechanisms described above through which non-business actors may influence tax policy could operate in the Argentine case.

Empirically, however, explanations based on the role of labor and popular sectors do not fit the two country cases. By and large, these actors in Argentina did not mobilize to demand higher taxation of economic elites.<sup>76</sup> Instead, they pursued their own direct economic self-interests. Policymakers aligned with labor or popular sector interests, including the Partido Justicialista (PJ), Argentina's historically populist party, did tend to favor taxation of elites and to resist regressive reforms, but so did Chile's center-left Concertación, despite the weakness of labor and the absence of popular mobilization. Further, executive branch policymakers in Argentina had an incentive for proposing elite-targeted tax reforms independent of labor or popular sector preferences: weak business power made taxing under-tapped elite resources feasible. Finally, although demands made by mobilized popular sectors in Argentina created revenue needs, this factor cannot explain differences in tax policy outcomes compared to Chile. Revenue needs arise in different ways and take various forms. In Chile, center-left politicians felt compelled to raise revenue in order to fund expanded social spending, even in the absence of popular mobilization to demand benefits. And in Argentina, fiscal imbalances were the primary factor that motivated policymakers to increase taxes in the 1990s and in the aftermath of the 2001 crisis. In short, policymakers in both Chile and Argentina experienced revenue needs that motivated them to pursue tax increases, despite the difference in popular sector mobilization. Instead, I will argue that business power explains most of the difference in tax policy outcomes between Argentina and Chile.

In Bolivia, however, popular sectors played a much more significant role in tax policy from 2003-2005 in the context of widespread social upheaval and rejection of the exclusionary political system and neoliberal economic model. As discussed in Chapter 7, popular sectors exerted influence through each of the mechanisms previously described. Popular sectors defeated a tax proposal they perceived as regressive through protest in 2003. That incident gave policymakers incentives to propose reforms highly targeted at elites in 2004 despite strong business power. And as part of a transformative social, economic and political agenda, mobilized popular sectors demanded higher taxation of the multinational-dominated hydrocarbons sector. In the latter two cases, popular sector mobilization to different extents counterbalanced business power.

### **International Factors**

Authors have identified various other international factors beyond higher capital mobility that may influence tax policy. These factors include IMF conditionality, policymakers' connections to epistemic communities, and pressures exerted by other international actors. International factors can certainly be important. They may affect policymakers' reform agendas, business power or even the government's reform strategy options. However, international factors provide relatively little leverage for explaining variation in tax outcomes observed in the cases this study examines. IMF conditionality played at most marginal roles in shaping tax agendas and/or influencing proposal outcomes. Epistemic communities are good indicators of the type of reforms policymakers will seek to implement but provide no information about which reforms will be deemed feasible options. Pressures from other international actors were

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<sup>75</sup>See Etchemendy and Collier (2007) for a discussion of this phenomenon and its causes.

<sup>76</sup>A partial exception involving popular sector organizations and export taxes in Argentina is discussed in Chapters 6 and 7.

relevant in only one policy area, and their influence was strongly mediated by domestic factors and business power.

### ***IMF Conditionality***

Pressure from the IMF and other international lending institutions is frequently cited as an influence on tax policy. In the 1980s and 1990s, many governments signed conditionality agreements with the IMF as a precondition for receiving financial assistance. These agreements in some cases specified overall fiscal deficit targets and in other cases explicitly required tax reform.<sup>77</sup> Not only may pressure from international institutions help define the reform agenda and encourage executives to initiate proposals (Lledo, Schneider and Moore 2004: 41, Abed et al 1998: 10), but conditionality may also help governments push these reforms through congress by granting the executive greater leverage in the form of the promise of substantial external resources (Mahon 2004: 9, Williamson and Haggard 1994: 567). Mahon (2004: 15, 19) codes IMF agreements for a large number of country-years and finds evidence from statistical analysis that IMF conditionality does in fact constitute a “major explanation” of first-generation tax reforms in Latin America, namely, increasing VAT rates, broadening VAT bases, lowering direct tax rates, and simplifying tax systems.

In the cases I analyze, however, financial institution conditionality played at most a marginal role in defining the tax agenda and/or determining the outcome of reform proposals.<sup>78</sup> International financial institution involvement in second-generation tax reforms varied across countries. In Chile, these institutions played essentially no role in tax reform following the 1990 transition to democracy. In Argentina and Bolivia, the IMF was a major source of aid and regularly set fiscal targets. The IMF advocated specific elite-targeted tax reforms in these countries, but they were not enacted. In Argentina, IMF officials recommended taxing interest earnings in the late 1990s, but that issue for the most part remained off the government’s reform agenda. In Bolivia, the IMF urged creation of an income tax in the early 2000s, but government policymakers viewed this reform as necessary independently of the IMF’s position. If IMF pressure influenced tax policy at all in this case, it contributed to the failure of the government’s income tax proposal. In a context of broad popular rejection of neoliberal reforms, the income tax was widely denounced as an illegitimate imposition by the IMF intended to extract resources for debt repayment. This dynamic conforms to Williamson and Haggard’s (1994: 566) observation that: “it is ... possible for foreign pressures to be ineffective or even, where nationalist sentiments are aroused, counterproductive.”<sup>79</sup> Further, Bolivian elites who opposed the reform may have expected that foreign assistance would materialize whether or not the tax reform passed. Similarly, Van de Walle (2001) and Leonard and Strauss (2003) argue that international lending institution conditionality in Africa has failed because governments anticipate that aid will continue even if they do not meet the stipulated terms of agreement.

### ***Epistemic Communities***

Theories based on epistemic communities or support groups may also provide insights on tax reform politics. Haas (1992: 3) argues that epistemic communities, namely, “network[s] of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge,” can influence policy by calling attention to specific issues and providing information and advice. Elkins and Simmons (2005: 41) further argue: “It is extremely helpful to have a community of users, preferably one with skills and knowledge, who are committed to refining and

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<sup>77</sup>For a review of international financial institution involvement in first-generation tax reforms, see Lledo, Schneider and Moore 2004: 39-42.

<sup>78</sup>In a similar vein, Weyland (2006: 215) finds that in the case of health care and pension reforms in Latin America, “External pressures, especially from international financial institutions, have supported policy diffusion but have not been decisive in initiating the process and determining its outcomes. Domestic policy-makers have retained considerable autonomy in their decisions.”

<sup>79</sup>Similarly, Elkins and Simmons (2005: 37) note that “Reforms in the United States, because of the country’s mixed international reputation, often inspire ... a polarized effect” in terms of policy adoption by other countries.

improving the practice. Adopting countries desire pools of expertise that they can draw on for policy enhancements and ancillary policies.”

Three specific hypotheses emerge from this literature. First, epistemic communities may help define the tax reform agenda. Just as informal ties to business might encourage policymakers to consider tax reforms that business prefers, connections to an independent community of experts might encourage policymakers to pursue reforms advocated by that community. Second, members of epistemic communities may participate directly in domestic tax politics. As Hass (1992: 4) observes, such individuals may “become strong actors at the national and transnational level as decision makers solicit their information and delegate responsibility to them.” Third, links to epistemic communities might strengthen policymakers’ political leverage. Just as business may draw on technical expertise to influence policy, government officials might draw on the expertise of epistemic communities to advance their goals. By extension, epistemic communities might serve to counterbalance business’s instrumental power.

Epistemic communities probably played some of these roles with respect to tax reform in Latin America in the aftermath of the debt crisis. International experts systematically advocated first-generation tax reforms during the 1980s and early 1990s, and like IMF conditionality, their efforts may have helped to define governments’ tax reform agendas.<sup>80</sup>

In the cases I analyze, epistemic communities were rarely relevant beyond the early stages of agenda formulation. While examining epistemic communities provides information about the reforms policymakers connected to those communities are likely to view as technically appropriate, epistemic communities played little role in shaping the set of reforms policymakers considered politically feasible, which is the primary focus of my analysis. In addition, government policymakers usually determined the reform agenda according to their own analysis and priorities before consulting with international experts on the details of proposal design.<sup>81</sup> In none of my cases did members of epistemic communities serve as central political actors in tax policy decisions. Governments occasionally called upon international experts as sources of technical expertise to legitimate the reforms they proposed.<sup>82</sup> However, just as technical expertise did not serve as a primary source of instrumental power for business in my cases, support from epistemic communities had a limited effect on the outcome of reform proposals.

My focus on business power rather than epistemic communities as the key to tax policy outcomes agrees with Shadlen’s findings in the realm of patent policy. Shadlen (2009: 43) argues that cross-national differences in patent policy are explained in large part by “the identity of actors receiving and attempting to implement the diffused idea of health-oriented IP [intellectual property], and the availability of powerful alliance partners for those actors advocating reform.” His research “provides a caution against overstating the significance of ideas and policy communities, and calls for renewed attention to traditional variables such as interests and resources,” (Shadlen 2009: 43).

### ***Pressures from Other International Actors***

Pressures from other international actors, including supra-national governance bodies, international economic communities, and foreign nations, may also influence tax policy. Appel (2006), for example, finds that tax harmonization requirements for joining the European Union significantly constrained domestic tax policy choices for new entrants. She observes that East European countries “ceded enormous control over indirect and most of direct tax policymaking” to authorities in Brussels (Appel 2006: 56-7).

Constraints associated with regional integration have tended to be weaker in Latin America. Regional integration certainly has not progressed as far as in Europe (Feng and Genna 2003: 284, 288),

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<sup>80</sup>See for example Fjeldstad and Moore (2008: 239-241) on epistemic communities and tax reform in Latin America and elsewhere. Their remarks primarily identify the existence of these communities without assessing exactly how or to what extent they have influenced the agenda.

<sup>81</sup>Examples include Argentina’s 1998 tax on interest payments (Chapter 6, Part 1) and Bolivia’s failed 2003 income tax proposal (Chapter 7). In both cases, the role of international advisors was primarily to assist in designing reform proposals to deal with tax issues that government policymakers wished to address.

<sup>82</sup>Examples include Chile’s 2000 Anti-Evasion reform (Chapter 4, Part 1) and Chile’s 2001 corporate tax increase (Chapter 3).

nor is it likely to (Kaltenthaler and Mora 2002); as such, the issue of ceding autonomy over tax policymaking to a regional organization is not relevant. Regional economic communities such as *Mercosur* negotiate agreements on tariff rates and encourage harmonization of exchange rates and other macroeconomic policies (Carranza 2003, Kaltenthaler and Mora 2002), but internal taxes lie outside the scope of these agreements.

However, other international actors did apply pressure in the specific area of tax agency access to bank information, which is critical for reducing income tax evasion. After 1998, the OECD pressured developing countries to bring their financial regulations into line with international standards by increasing transparency, due to concerns over large-scale tax avoidance through use of tax havens (Sharman 2006). For example, developed countries increasingly demanded tax agency access to bank information and information exchange as prerequisites for signing double-taxation treaties. Most importantly, pressure from the US to loosen banking secrecy regulations intensified after the 2001 World Trade Center attacks due to concern over money laundering connected to terrorism.

Yet these pressures alone cannot account for variation in expansion of tax agency access to bank information across countries (Figure 2.11). Both Chile and Argentina experienced similar international pressures, especially from the US, but bank information access remained quite restricted in Chile as of 2009, whereas Argentina's tax agency had obtained full and autonomic access by 2006. Domestic factors and business power strongly mediated the influence of international pressures in both cases. In Argentina, international concern over money laundering played an indirect role in facilitating reform by helping to weaken business power with respect to this policy area. But domestic developments, namely, Argentina's 2001 crisis, were critical for reducing business power (Chapter 6). In Chile, meanwhile, international pressures proved inconsequential during the primary period analyzed, thanks to strong business power and opposition to reform. New international pressures similar to those discussed by Appel (2006) created political space for progress in this policy area in 2009—during the final stages of Chile's application process, the OECD made reform to loosen banking secrecy an explicit prerequisite for securing much coveted membership in the organization. However, the limited scope of the reform proposed by the government can only be understood by analyzing business power.

### **Institutional Explanations**

This section examines two sets of institutional arguments that have been made to explain differences in the tax burdens imposed on economic elites across countries. These arguments identify federalism and institutional instability as factors that lead to lower taxation of elite resources. Both arguments make incorrect predictions for the countries I examine.

Although I find limitations and/or flaws in these arguments, I agree that institutions matter. Within my framework, institutions play a role in determining the nature of business power, the reform agenda, and executives' reform strategies. For example, party systems shape business's instrumental power in the legislative arena, business organization affects cohesion and hence instrumental power, and budgetary institutions can shape the executive's choice of reforms and strategies. However, an exclusive focus on institutions is inadequate; business power, reform choices, and policy outcomes cannot be reduced entirely to institutional variables. For example, business may enjoy instrumental power in the executive arena across a wide range of institutional settings, ideology as well as organization affects business cohesion, and formal rules are often circumvented or adjusted to accommodate powerful actors.

### ***Federalism***

The literature on fiscal federalism suggests that tax increases targeting economic elites are less likely to occur in federal states, where taxes are subject to automatic revenue-sharing rules, than in unitary states, where taxes collected by the central government are not transferred to subnational units. Because the central government in federal states retains only a fraction of the tax revenue it collects, executives have incentives to reduce spending instead of raising taxes when fiscal adjustment becomes necessary (Saiegh and Tommasi 1999: 181), or to create new taxes, contributions, or fees that side-step existing revenue-sharing rules and may not be as progressive as traditional direct taxes. Accordingly, the tax

agenda in federal states is less likely to include revenue-raising proposals that involve taxation of income and profits.

The fiscal federalism argument cannot fully account for the scope of the tax agenda in the countries I analyze. Although the incentives identified in this literature did operate in Argentina, a federal state where provinces relied heavily on revenue-transfers from the center, Argentine governments in fact repeatedly, and successfully, attempted to increase taxes subject to revenue-sharing, including taxes on income and profits. Even in the context of growing reliance on taxes exempt from revenue-sharing after 2001, governments endeavored to raise more revenue from taxes shared with the provinces by implementing anti-evasion reforms. In contrast, governments in Chile, a unitary state, rarely proposed direct tax increases, or significant tax increases of any kind for that matter, even in the absence of any disincentives associated with revenue-sharing.

Lieberman (2003) also maintains that it is more difficult to tax elites in federal states compared to unitary states, based on the previously discussed argument that elite fragmentation hinders elite taxation. In federal states, regional cleavages among elites are institutionalized, and Lieberman (2003: 257) argues that elites perceive taxation by the central government as inherently redistributive and zero-sum:

The fragmentation of economic classes that becomes reinforced when the NPC [National Political Community] is defined as a federation makes the direct taxation of upper groups much more difficult because upper groups in wealthier regions tend to perceive the imposition of taxation as an attempt to divert resources to “them” rather than to be used for one of “us.”

This observation is relevant for various Latin American countries, particularly those in which wealth and resources are geographically concentrated.

Again, however, federalism is not a good predictor of tax policy outcomes in the cases I examine; direct tax increases were more difficult and more marginal in Chile compared to Argentina. The federal vs. unitary state variable is unsatisfactory for my purposes for three reasons, several of which are related to my previous critique of Lieberman’s treatment of fragmentation vs. cohesion. First, unitary states can also have cohesive subnational economic elites who strongly oppose the central government’s efforts to appropriate their resources, as in Bolivia, where elites in the wealthy eastern lowlands have come into increasing conflict with the national government for control over tax revenue originating from their regions (Eaton 2007).

Second, the federal vs. unitary state variable is not necessarily correlated with economic elites’ tax preferences. On the one hand, elites in federal states may not oppose taxation as strongly where the subnational units in which they reside rely on revenue transfers from the central government, as in Argentina. In these contexts, elites may not perceived taxation as a strictly zero-sum game. On the other hand, elites in unitary states may perceive taxation as a zero-sum game that redistributes resources to other groups, whether regionally or socio-economically demarcated, depending on the manner in which the government allocates tax revenue. Tax revenue can be redistributed across classes, as in Chile, where spending is targeted to low-income groups. Tax revenue can even be redistributed across subnational jurisdictions in unitary states. For example, property tax revenue in Chile is redistributed from a handful of wealthy municipalities located in eastern Santiago to poorer municipalities elsewhere in and beyond the capital.<sup>83</sup> Similarly, a large fraction of total tax revenue in Bolivia originates from the eastern lowland department of Santa Cruz, but government spending redistributes much of this revenue to the poor western highlands.<sup>84</sup>

Finally, even where federalism is correlated with especially strong elite opposition to taxation based on the logic Lieberman describes, elites may simply lack sources of power that would allow them to influence policy. For example, agricultural elites in Argentina’s interior provinces fervently opposed

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<sup>83</sup>Revenue from these taxes, which are legislated at the national level and collected by the central government, is earmarked for municipalities; however, a significant proportion of the revenue enters a common pool allocated through redistributive criteria.

<sup>84</sup>Cossio (2006: 135) demonstrates that spending in Bolivia is progressive; poverty is concentrated in the western highlands. From 2002-04, 37% of all tax revenue originated in the department of Santa Cruz ([www.impuestos.gov.bo](http://www.impuestos.gov.bo)).



export taxes, implemented after 2001, which redistributed resources from the countryside to urban centers in the province of Buenos Aires. Because these taxes were not subject to automatic revenue-sharing, the government was able to allocate the revenue to its urban constituencies and provincial governors aligned with the president's political coalition. Despite their strong opposition, however, agricultural elites were unable to resist repeated export tax increases over a period of nearly seven years, until 2008, when producers managed to stage a series of massive capital strikes that eventually forced the government to meet some of their demands (Chapter 6, Part 2).

### ***Institutional Instability***

Authors who study Argentina have identified institutional weakness as a key explanatory variable for a wide range of political and economic outcomes (O'Donnell 1994, Tommasi and Spiller 2000, Levitsky and Murrillo 2005, Tommasi and Spiller 2007). Melo (2007) draws on this research, as well as literature on strategic incentives created by weak institutions (Cukierman et al. 1989, Edwards and Tabellini 1991), to explain Argentina's low levels of aggregate taxation compared to Brazil.

Melo (2007) argues that institutional instability creates disincentives for building long-term tax capacity by shortening governments' time horizons. Where institutional instability or "instability of the political environment" more generally prevails,

...governments choose to extract resources... through inflation rather than normal taxation. In addition, governments in these environments will tend to collect taxes that require less effort on the part of the state (e.g., customs taxes, bank debit and credit taxes), as opposed to income, property, and, to some extent, value-added taxes. (Melo 2007: 117).

Conversely, governments are more likely to strengthen tax agencies and avoid inflationary financing when instability is low. The underlying logic is that presidents with short time horizons can rest assured that they will reap the benefits of increasing easily-collected taxes, whereas the benefits of increasing direct taxes or investing in administrative capacity may accrue only to future leaders.

Melo's (2007) argument does not correctly predict differences in tax outcomes across Chile and Argentina.<sup>85</sup> In Chile, tax capacity stagnated after the 1990 democratic transition, and key reforms needed to strengthen the tax administration's auditing capacity were not initiated, despite high levels of institutional stability, economic stability, and political stability. Chile's strong institutions and robust economy are the envy of Latin America. Moreover, a single political coalition with demonstrably long time horizons occupied the executive branch from 1990 through 2009. In Argentina, in contrast, corporate tax revenue grew steadily from 1992 to 2006, excepting shortfalls caused by the 2001 economic crisis, and administrative capacity improved thanks to multiple reforms designed to control tax evasion and tax avoidance, despite the fact that Argentina is an example *par excellence* of institutional, political, and economic instability. Remarkably, the Argentine tax agency is now more powerful and more sophisticated than the Chilean tax agency, which was long reputed as the best in the region, in terms of access to bank information and various other capacities.<sup>86</sup> Melo's (2007: 155) characterization of Argentina as a country that "has not learned to tax" overlooks important advances in these areas.

Melo's argument also fails to adequately explain the timing of reforms to strengthen the tax agency and fight evasion in Argentina. He accommodates advances in these areas from the early 1990s within his framework by treating the Menem era as a period of reduced instability, thanks to currency

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<sup>85</sup>Melo does not include Chile in his case universe because its per capita GDP is not large enough to categorize it as an upper middle income country, and tax revenue as a percent of GDP is correlated with per capita income. However, Chile and Argentina have very similar GDP per capita at purchasing power parity, which also provides a reasonable indicator of potential revenue capacity. Moreover, Melo's argument about instability and politicians' incentives should apply regardless of developmental level.

<sup>86</sup>Control over transfer prices is more advanced in Argentina than in Chile. Control over VAT evasion through the use of false receipts in Argentina has advanced beyond European capabilities, and the Argentine tax agency's information systems are now the most sophisticated in the region, if not worldwide (author interview, AFIP 2006). Major advances have also been made toward controlling evasion in Argentina's agricultural sector, which comprises numerous, geographically dispersed producers.

stabilization and reduced political competition after the Peronist's solid defeat of the Radicals, and he observes that backsliding took place in the form of increased turnover in the tax agency directorship in the late 1990s when new sources of instability emerged (Melo 2007: 138). However, concrete initiatives to improve administration and control evasion in fact continued during the period of renewed political and economic instability spanning from the end of Menem's second administration, when the Peronists' continuation in power was no longer secure and the economy was suffering the effects of the East Asian crisis, through the Radical administration of De la Rúa, which collapsed after the 2001 economic crisis, to the Peronist administrations of Duhalde and Kirchner. Kirchner, for example, undertook important anti-evasion reforms shortly after assuming the presidency in 2003, at a time when according to Melo's argument, he should have had short time horizons that would have discouraged such efforts: it was not yet clear that the Argentine economy had recovered from the crisis, and Kirchner's legislative coalition and prospects for continuation in power did not consolidate until 2005 (Garay and Etchemendy, forthcoming: 10). Even during Alfonsín's presidency in the 1980s, which Melo (2007: 131-2) characterizes as a period of high political instability, the executive proposed reforms to strengthen the tax agency and fight evasion.<sup>87</sup> That executives initiated and fought to pass reforms designed to strengthen long-term tax capacity across a wide variety of political and economic contexts illustrates the limitations of seeking to explain tax outcomes based on imputed incentives associated with instability, whether institutional, economic, or political. Further, despite turnover of the tax agency director during the late 1990s, career bureaucrats with significant accumulated technical expertise moved up into mid-level and high-level leadership positions in the tax agency. As Bergman (2009: 78) observes: "Since 1990, 95 percent of the top managerial posts have been professionally oriented and internally promoted." The heads of all the tax agency's subdivisions as of 2007 were professionals who had worked in the tax agency since the early 1990s (author's interviews: AFIP C, D, E 2006).

In sum, while Melo's argument may contribute to understanding development of tax bureaucracy and tax capacity over very long timeframes, it is not adequate for explaining when policymakers attempt to increase elite taxation—by reforming tax policy or empowering the tax agency—or why such attempts fail or succeed.

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<sup>87</sup>For example, the administration passed pioneering legislation that opened the way for the tax agency to obtain access to bank information, among other efforts to strengthen the tax agency and fight evasion.

### Chapter 3. Corporate Taxation in Chile: Strong Instrumental Power Restricts the Government's Agenda

*“If you compare the tax structure of Chile with the US or others, you will see that the proportion of indirect taxes—taxes on consumption—over the total tax burden is VERY high, and the proportion of direct taxes to ones that are more proportional to the level of wealth are very, very low. And that is because of a political problem.”*

*—Former Finance Minister Nicolás Eyzaguirre  
(author's interview, 2005)*

In the extraordinary context of Chile's 1990 transition to democracy, the newly elected center-left Concertación coalition increased the corporate tax from 10% to 15%, but subsequent corporate tax reforms were marginal. Chile's corporate tax rate remained the region's lowest in 2008 at 17%,<sup>1</sup> (Figure 2.1), and reforms to close loopholes and fight evasion focused on indirect taxes rather than direct taxes. Consequently, corporate tax collections held essentially constant in Chile at an average of 2.4% GDP from 1993-2004 (Figure 2.2). Although widely cited research has characterized Chile as a progressive tax reform success story based on the 1990 reform (Weyland 1997), increasing the corporate tax remains one of the most important reforms needed to build tax capacity and improve tax equity in Chile.

Top leaders in the Lagos administration (2000-2005) believed tax revenue in general and corporate taxation in particular were too low. The former President and his Finance Minister, Nicolás Eyzaguirre, lamented that prevailing revenue levels could not support sufficient social spending and provision of public goods:

There is a relation between a country's tax burden and the social benefits that country provides. And 18%, for a country the size of Chile is very little. ...I think that there is going to have to be a serious debate on the issue of taxation in Chile. (Lagos 2006, author's interview and translation)

You will not find any country in the world with per capita income in PPP [purchasing power parity] of 14000 and above with a lower tax burden. We are [in a] corner. It is *obvious* that we have to increase ... public goods, including education, research and development, social protection... (Eyzaguirre 2007, author's interview)

Eyzaguirre emphasized Chile's low direct tax revenue and asserted that the corporate tax should be much higher. Concertación legislators also agreed that the corporate tax was much too low.<sup>2</sup> However, the administration increased the corporate tax to only 17%, still short of the Concertación's modest original target of 20% for the 1990 reform.

This chapter argues that business's strong instrumental power, based on partisan linkages, cohesion, and an informally institutionalized pattern of government-business concertation, kept all but marginal corporate tax reforms off the agenda in Chile. Section I explains why the integrated structure of Chile's income tax makes increasing the corporate tax rate so important for improving tax capacity and tax equity. Section II argues that structural power cannot explain why significant corporate tax reform remained off the agenda throughout the Lagos administration; top policymakers for the most part were not concerned that increasing the corporate tax would harm investment. Section III identifies the three main sources of business's strong and persistent instrumental power and explains the mechanisms through which these sources of power allowed business to restrict the tax agenda. Partisan linkages involving Chile's two right parties helped business block reforms in Congress, and cohesion allowed business to effectively mobilize against tax increases. Meanwhile, government-business concertation on economic

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<sup>1</sup>Brazil's statutory rate is 15%, but other corporate taxes apply. Effective corporate tax rates are not available for Latin America.

<sup>2</sup>See Lorenzini et al. 2006: 28, author's interviews with Eyzaguirre (2007) and legislators: Bitar 2006, Boeninger 2005, Burgos 2005, Escalona 2007, Foxley 2006, Gazmuri 2006, Nuñez 2006, Ortiz 2005, Sabag 2006, Silva 2006, Tuma 2005, Valenzuela 2006, Zaldivar 2007.

policy created incentives for the government to avoid conflict with business on taxation. I illustrate these analytical points by examining a case of marginal corporate tax reform in 2001, as well as episodes of corporate tax non-reform from 2000-2005. Section IV revisits the 1990 reform, which I argue is best understood as a limited, one-time concession by business and the right in the context of uncertainty accompanying the transition to democracy. Finally, Section V examines tax politics during the Bachelet administration (2006-2009). I argue that business's instrumental power remained strong despite changes in the nature of the relationship between business and the right. Instrumental power, along with the Finance Minister's more orthodox views on taxation and perception of structural power on the one hand, and a new economic context characterized by slow growth and record fiscal surpluses associated with skyrocketing copper prices on the other hand, ensured that corporate tax reform would remain off the agenda.

**Figure 2.1: Corporate Income Tax Rates in Latin America, 2004.**

Sources: Price Waterhouse Coopers (2003), Gómez Sabaini (2005)

Country	CIT rate	Country	CIT rate
Colombia	37%	Panama	30%
Argentina	35%	Peru	30%
Paraguay	35%	Bolivia	25%
Venezuela	34% *	Ecuador	25%
Mexico	32%	Honduras	25% *
Guatemala	31%	Nicaragua	25%
Uruguay	30%	El Salvador	25%
Costa Rica	30%	Brazil	24% **
		<b>Chile</b>	<b>17% ***</b>
<b>Average, including Chile†</b>	<b>29%</b>		
<b>Average, excluding Chile†</b>	<b>30%</b>		

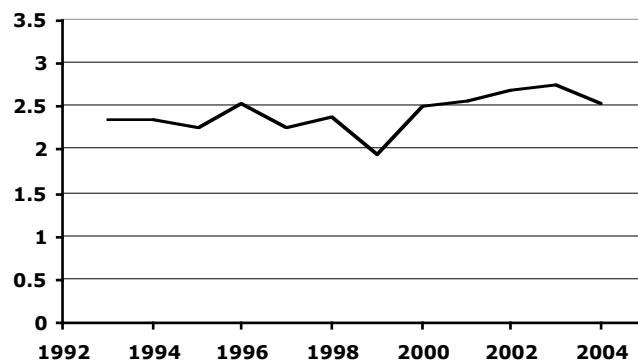
\*These countries have a progressive CIT with multiple rates and brackets. I have listed the maximum values. Minimum values are 14% in Venezuela and 15% in Honduras.

\*\*This is a minimum effective rate. Brazil has a CIT of 15%, "social contributions" of 9% on the same corporate tax base, and a surcharge of 10% on sales over about USD 68,000.

\*\*\*Rate on retained profits. †Using the maximum rate where relevant.

**Figure 2.2: Corporate Tax Revenue (% GDP), Chile**

Source: SII: Serie Ingresos Públicos (www.sii.cl)<sup>3</sup>



<sup>3</sup>Constructed with help from Jorratt. I end the series in 2004 since in 2005, booming copper prices exogenously increased tax revenue.

## I. The Rationale for Increasing the Corporate Tax

Increasing the corporate tax is critical for raising revenue and improving equity in Chile because of the way the income tax is structured. Chile's income tax is integrated: the corporate tax (CT) is essentially a withholding on the personal income tax (PIT) on distributed profits. Profits reinvested in the firm pay only the 17% CT. But dividends enter the recipient's PIT base and are taxed at much higher rates—the top marginal personal income tax rate is 40%. The CT already collected at the firm level is credited against the recipient's PIT when dividends are distributed, such that corporate profits are not “double taxed.” This integrated income tax system was implemented in 1984 by the Pinochet dictatorship as a mechanism to encourage investment after the 1982 economic crisis (Ministerio de Hacienda 2005: 92).<sup>4</sup> Because the gap between the CT and the PIT is so large, capital owners do in fact leave the majority of their profits in the firm, where they pay the much lower tax rate. On average, firms retain 65% of their profits annually (Jorratt 2005, author's interview).

The large gap between the CT and the PIT also stimulates widespread tax avoidance. There are many ways in which capital owners can consume profits through the firm, without formally withdrawing dividends and hence without ever paying the corresponding PIT. For example, vehicles may be registered as property of the firm, although in practice they may be for the owner's personal use, and other goods and services destined for individual consumption may be purchased on a company account. Moreover, many such purchases can be deducted from the company's corporate taxes as costs necessary for production.<sup>5</sup> Meanwhile, independent professionals engage in tax avoidance by creating incorporated “investment societies,” which transform income that would otherwise be subject to the high PIT rates into corporate income taxed at only 17%.<sup>6</sup> There are essentially no controls to prevent the formation of corporations for the sole purpose of avoiding taxes.

In addition to tax avoidance, income tax evasion through under-declaration of distributed profits is very high. Total income tax evasion is on the order of 50% (Jorratt 2005, author's interview), and corporate income tax evasion from 1995 to 1997 was estimated at 41% (Jorratt and Serra quoted in Cetrángolo and Gómez-Sabaini 2007: 89).<sup>7</sup> Controlling income tax evasion is quite challenging. In the case of close corporations, the tax agency has no way of verifying whether or not distributed profits have been fully declared by their owners without undertaking audits on a firm-by-firm basis.<sup>8</sup> Moreover, the tax agency lacks automatic access to bank information on taxpayers' checking accounts, which would make it much easier to detect undeclared income on tax returns.<sup>9</sup>

Income tax avoidance and evasion are problems primarily among the richest taxpayers. Only dependent workers, whose paychecks are subject to automatic withholding by their employers, are unable to avoid or evade income taxes. Capital owners and independent professionals, who can avoid or evade income taxes, tend to be much wealthier than dependent workers. In 2003, the ratio of profits to all other

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<sup>4</sup>The 1984 tax reform was also one of several economic reforms implemented to regain the loyalty of the business sector, in light of the possibility that organized business might join with popular protest against the military regime (Silva 1998: 231). The tax reform reflected demands made by the CPC (Silva 1998: 231).

<sup>5</sup>Former Finance Minister Alejandro Foxley (2005, author's interview) explains the situation as follows: “Si tu vas al supermercado hoy día, es una vergüenza. Hay una caja especial en algunos supermercados en que dice ‘factura.’ Va la dueña de casa, cuyo marido trabaja en una empresa, llena de mercadería—sus cosas para toda el mes, y aparece como costo de la empresa. Tax deductible. Un gasto necesario para generar la renta de la empresa. Imaginate.”

<sup>6</sup>Individuals can also form corporations with other family members. If profits need to be withdrawn, they can be distributed to the family member with the lowest income, such that the distributed profits avoid the highest marginal rates of the personal income tax (Agostini 2005, author's interview).

<sup>7</sup>Corporate and personal income tax evasion is partly due to VAT evasion, as well as under-declaration of assets and dividends.

<sup>8</sup>Publicly traded corporations provide the tax agency with information regarding profits distributed to shareholders, which can then be cross-checked against personal income tax declarations. In the case of closed corporations, however, there is no reliable third party that could provide information to the tax agency on distributed profits, since the firm owners who receive the distributed profits are essentially the same parties responsible for maintaining the corporate profits registry (Jorratt 2005, author's interview).

<sup>9</sup>As of September 2009, if the tax agency audited a taxpayer based on identified irregularities, it could obtain information on that taxpayer's deposits with a judge's authorization, but it could not use deposit information as a tool to detect evasion. See Chapter 6, Part 1 for further discussion.

forms of income exceeded unity only for taxpayers in the top centile of the adult population (Figure 2.3). The ratio of profits and income from independent professional work to wage income was less than one for taxpayers below the top centile, but reached 7 for the top 0.1%.

Accordingly, average effective income tax rates paid by the wealthiest Chileans are very low (Figure 2.3). In fact, they are even lower than 17% because of special dispositions in the CT legislation, such as accelerated depreciation, unlimited tax loss carry-back and carry-forward,<sup>10</sup> presumed income regimes (simplified tax regimes for small and medium contributors) in agriculture, mining, and transportation, and various tax credits and deferrals (SII 2000b, 2005).

Not only do the very rich pay low income taxes, but the tax base they control is quite significant. The top 1% of taxpayers accounted for 37% of all profits and income reported to the tax agency in 2003—fully 15% of GDP. But the top 1% paid an average effective income tax rate (individual and corporate taxes) of only 12%; the top 0.1% received 7% of profits and income but paid only 13%. By comparison, in the US in 2004, the top 1% paid an average effective rate of 24% in federal income taxes alone; the top 0.1% paid 29% (Piketty and Saez 2006: 51). If the effective tax rate for the top 1% in Chile were the same as in US (e.g., double the present rate), the state would raise additional tax revenue equivalent to 2% of GDP—from that top 1% alone.

A number of reforms could help increase taxation of these highly concentrated income and profits. One possibility is to close loopholes that facilitate personal income tax avoidance involving consumption through the firm. Another option is to impose restrictions on the formation of investment societies and other closed corporations. A third option is to increase the corporate tax. All of these alternatives have been considered by Concertación governments since 1990.

High-level policymakers in the Lagos administration and tax agency officials identified increasing the corporate tax as the simplest and most effective way to increase taxation of under-tapped income and profits (author's interviews: Eyzaguirre 2007, Etcheverry 2005). In their view, as long as the gap between the corporate and personal income taxes remains large, taxpayers will have strong incentives to find ways to avoid or evade the personal income tax, and the tax agency will find itself in a constant struggle to outwit tax advisors in the private sector (Eyzaguirre 2005, author's interview). As such, increasing the corporate tax may be the most important reform for improving tax equity and tax capacity in Chile.

**Figure 2.3: Shares of Reported Income and Corporate Profits and Average Tax Rates (%), Chile 2003.**

Source: Author's calculations using a database compiled by Michael Jorratt.<sup>11</sup>

<b>Cumulative Percentile*</b>	<b>Share of Reported Income and Profits</b>	<b>Reported Income and Profits as Percent of GDP</b>	<b>Ratio of Profits to Other Income</b>	<b>Ratio of Profits and Independent Professional Income to Wage income</b>	<b>Average Tax Rate**</b>
<b>Top 10%</b>	81	33	0.4	0.7	6.8
<b>5%</b>	64	26	0.6	0.9	8.3
<b>1%</b>	37	15	1.2	1.8	12
<b>0.1%</b>	17	7.0	4.0	6.9	13
<b>0.06%</b>	14	5.6	5.4	11	12

\*Individuals over age 20.

\*\*Taxes paid (corporate and individual income taxes) divided by reported income.

<sup>10</sup>Most countries restrict loss carry-forward and carry-back to a fixed number of years.

<sup>11</sup>This database imputes corporate taxes and retained corporate profits to their owners. This methodology differs from Piketty and Saez (2006), who assume corporate taxes in the US are born proportionally to total capital income, including pensions. Applying their assumption to Chile would lower average tax rates at the top of the distribution. Piketty and Saez (2006) do not impute reinvested corporate profits, since realized capital gains on stocks in the US are of comparable magnitude. For Chile, it is more appropriate to impute retained profits because few companies are publicly traded, and only 35% of profits are distributed annually (Jorratt 2005, author's interview).

## II. Business's Weak Structural Power

I argue that business's structural power with respect to corporate taxation was weak in Chile during most of President Lagos's tenure in office, in contrast to the early 1990s, and contrary to both the Chilean business sector's arguments and predictions based on international tax competition literature (Chapter 2). Structural power was weak because top policymakers did not anticipate that corporate tax increases would harm investment; a strong case can be made that reform would not have substantially altered investor's behavior.

In the context of the democratic transition, structural power in the early 1990s was fairly strong. Business, which had supported Pinochet, was distrustful of the Concertación's commitment to the dictatorship's "pragmatic" neoliberal economic model (Silva 1996). Winning business confidence was therefore a real concern for the center-left Concertación when it took office in 1990 (Silva 1996: 231). That businesspeople might send their capital abroad or withhold investment in response to major tax increases was a concrete possibility in the context of uncertainty surrounding the transition.<sup>12</sup> A decade later, however, the Concertación had demonstrated both its commitment to respecting the neoliberal model and its ability to govern the economy responsibly, maintaining macroeconomic stability and achieving high growth rates to the business sector's great profit.<sup>13</sup>

Issues of business confidence aside, two different positions regarding the affect of corporate tax increases on investment incentives can be discerned among Chilean economists. One position maintains that the large gap between the low corporate tax and the high personal income tax is in fact a major incentive for capital owners to reinvest their profits and has contributed substantially to Chile's high national savings rate.<sup>14</sup> Economists who subscribe to this position assert that increasing the corporate tax and thereby decreasing the gap would cause investment to decline and could harm growth. A second position holds that there is no empirical evidence in support of the claim that the low corporate tax rate promotes investment. One study found that increasing the corporate tax rate in Chile could in fact raise the aggregate long-term demand for capital, and that investment decisions made by Chilean corporations were independent of the personal tax rates paid by their shareholder (Bustos et al. 2004).

Top policymakers in the Lagos administration subscribed to the second view—they perceived no threat of disinvestment in response to higher corporate taxes (author's interviews: Eyzaguirre 2007, Etcheverry 2005). According to the former Finance Minister, "The argument that you favor investment if the personal tax rate is way above the corporate tax rate is fallacious," (Eyzaguirre 2007, author's interview). In his analysis, instead of promoting investment in productive assets, the low corporate tax merely facilitates personal income tax avoidance and evasion on the part of capital owners and independent professionals:

...they pay 17% [corporate tax] and manage to spend the revenues as part of the company, but that is personal consumption. ... it is appropriate to integrate [the corporate and personal income taxes], because if not you double tax, but set the corporate tax at the highest personal income tax rate. If not you are giving the choice of whether to pay 17% or 40%. Imagine what avenue they are going to choose. (Eyzaguirre 2007, author's interview)

Eyzaguirre (2007, author's interview) viewed business's complaints that increasing corporate taxation—either by raising the tax rate or by closing loopholes—would discourage investment as non-credible threats:

They were trying to argue that the economy was going to stop, that investment was going to stall, that ...small and medium enterprises were going to collapse... my team

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<sup>12</sup>Based on a 1992 interview with Manuel Marfán, Silva (1996: 232) in essence concludes that structural power with respect to tax reform was high in the early 1990s: "[the Concertación] could not raise much financing through taxation, which business considered to be confiscation. Moreover, many changes to the tax code might discourage the private sector from investing or cause it to flee Chilean borders."

<sup>13</sup>Early in the Lagos administration, however, during the economic recession related to the East Asian crisis, policymakers did feel a need to prove their ability to manage the economy responsibly. See Chapter 4, Part 1.

<sup>14</sup>See for example Cerda and Larraín 2005.

was a very serious team, in terms of knowledge of sound economic theory—the arguments were nonsense.

Eyzaguirre did harbor concerns that increasing direct taxes could have had a negative economic impact during Lagos' first year in office, when the Chilean economy was still suffering a recession related to the East Asian crisis (see Chapter 4). But such concerns were not relevant in subsequent years; the economy soon recovered and growth reached 6%.<sup>15</sup>

Investment outcomes in the aftermath of the 1990 tax reform support Eyzaguirre's position on corporate taxation—although Chilean businesspeople clearly dislike paying taxes, their investment behavior does not appear to be very sensitive to tax rates. After the five-point corporate tax increase in 1990, private investment surged, and the economy grew at even higher rates than it had under the dictatorship. Some businesspeople even admit that a corporate tax of 20% would have no impact on the economy (author's interviews: ABIF 2005, CChC 2005, Finance Ministry B 2005). One business leader who had actively opposed corporate tax increases even offered the following retrospective evaluation of the two-point 2001 corporate tax increase: "se ha podido manejar perfectamente... al final terminó mejorando la productividad de las empresas," (Aritzía 2005, author's interview).

Turning to foreign investors, international tax competition arguments are of limited relevance to the corporate tax rate due to the structure of the income tax. It is the 35% withholding tax on repatriated profits (the analog of the 40% individual income tax for Chilean citizens), not the 17% corporate tax, that is most relevant for foreign investment decisions.<sup>16</sup> The integrated income tax system with the low corporate tax rate on retained profits allows investors to partially defer payment of the withholding tax (SII 2005: 73). While this tax deferral may make Chile more desirable for foreign investors all else equal, increasing the corporate tax rate does not change their overall tax burden, aside from differences in the present and future value of tax payments. Further, Chile proved highly attractive to foreign investors in other dimensions such as fiscal, monetary, and regulatory policy; consequently, Chile ranked within the top thirteen countries on the Heritage Foundation's Economic Freedom Index from 1997 to 2007. Such a favorable overall policy environment may well reduce foreign investors' sensitivity to corporate tax rate increases, following Gelleny and McCoy's (2001) argument that government policy in other areas can offset the costs of higher taxation.

### **III. Business's Strong Instrumental Power**

I argue that business's strong instrumental power created significant political obstacles to reform that kept all but marginal corporate tax increases off the agenda, even in the absence of structural power. Instrumental power in Chile arose from three main sources: cohesion, partisan linkages, and an informally-institutionalized pattern of government-business relations involving concertation with business associations. Cohesion served as a valuable resource that allowed business to effectively mobilize against tax increases. Partisan linkages to the right-wing opposition parties afforded instrumental power in Congress, and concertation afforded instrumental power with respect to the executive branch. These multiple sources of instrumental power allowed business not only to influence the fate of reform proposals, but also to influence the scope of the reform agenda. Whereas earlier work by Silva (1996, 1998) emphasized business's ability to win modifications to the text of reform proposals, I find that business's influence over the reform agenda was much more consequential. My analysis therefore suggests that business power in Chile is stronger than previously recognized. For the most part, business did not have to mobilize against corporate tax increases—the mere threat of business opposition deterred the Lagos administration from attempting anything but marginal tax reform.

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<sup>15</sup>Structural power could have come into play in the venue of the legislature, had the executive proposed increasing the corporate tax to above 25%. Some important Concertación politicians and technocrats outside the Lagos administration did believe that a corporate tax rate over 25% might deter investment (author's interviews: Foxley 2006, Marfán 2005). However, there was a broad consensus within the coalition that raising the corporate tax to a little above 20% would have had a marginal if any effect on the economy.

<sup>16</sup>Forbes for example uses Chile's 35% withholding tax rate, not the 17% corporate tax rate, in its "Capital Hospitality" rankings. *El Mercurio*, April 5, 2007.



## Cross-Sectoral Cohesion

Business in Chile has a remarkable capacity to unite and engage in collective action. Business tends to band together in opposition to tax increases, and opinions dissenting from the consensus position on tax issues are rarely voiced in public. This cohesion arises from strong organization as well as shared anti-statist economic ideology.

Chile's encompassing associations are among the strongest in Latin America, thanks to a history of redistributive threats combined with state incentives for business to organize (Schneider 2004: 152, Silva 1998: 219, 221). The *Confederación de Producción y Comercio* (CPC), Chile's economy-wide business association, was founded in 1933 in response to labor mobilization and leftist threats (Drake 1978: 102, Schneider 2004: 154);<sup>17</sup> it is the oldest such association in the region. Its directorate is composed of the presidents of each of Chile's six sectoral peak associations (industry, mining, construction, finance, agriculture, and commerce), which have substantial resources and membership. The CPC is highly respected within the business community. According to former CPC president Ricardo Ariztía (2005, author's interview): "la CPC tiene un prestigio casi—me atrevería decir—incondicional ...del sector empresarial."

The CPC's strength lies in its ability to coordinate lobbying on issues of common concern and to forge consensus across sectors.<sup>18</sup> In the words of Ariztía (2005, author's interview): "Los empresarios en Chile, somos absolutamente unidos. Podremos discutir de ...mil cosas, pero en el momento de actuar ante situaciones complejas, los empresarios son una sola voz. Y eso ha sido desde que funciona la CPC." The CPC coordinated opposition to redistributive threats from Eduardo Frei's reformist government in the 1960s, which sought to implement land reform, and from Salvador Allende's Socialist government in the 1970s, which pursued more radical redistributive policies and nationalization (Schneider 2004: 162-3). Along with the *Sociedad de Fomento Fabril* (SOFOFA), the industrial association, the CPC led business resistance to Allende and helped bring Pinochet to power (Silva 1996: 44-48). The CPC's role of forging cross-sectoral consensus on economic policy became particularly important after the 1982 economic crisis. Pinochet marginalized organized business after the coup while he carried out radical economic restructuring, but the 1982 crisis compelled him to negotiate with the business associations in order to undermine political opposition to his regime (Silva 1996). The CPC became the main interlocutor between policymakers and the business sector: "major lobbying initiatives had to be conducted in the name of the CPC, not of individual sectoral organizations. Otherwise, technocratic policymakers dismissed them on the basis that narrow, selfish, sectoral interests were attempting to undermine the general good," (Silva 1997: 169).

Although the CPC's importance relative to the sectoral peak associations (especially SOFOFA) has varied over time (Silva 1998: 220, Schneider 2004: 153, 168-9, 171), the CPC has remained a key interlocutor between government and business since the democratic transition. The CPC has had more immediate access than the sectoral associations to high-level government officials, including the President and the Finance Minister, and it has been highly active on tax issues (Morandé 2005, author's interview). When asked about the relative importance of the CPC's efforts to represent business's interests compared to the sectoral associations in the case of a major "Anti-Evasion" tax reform in 2000, the CPC's former General Manager (2000-2005) replied:

Creo que fue muy importante, porque nosotros recogíamos opiniones de todos los sectores. ...Entonces nosotros representamos una oposición más consolidada porque los oíamos y los representamos a todos. Si habían cosas que eran específicas a un sector, era el gremio respectivo el que se hacía cargo, con el respaldo detrás de la CPC. (Urenda 2007, author's interview)

Business leaders and staff from the sectoral associations also agreed that the CPC played an important role in coordinating opposition to tax increases (author's interviews: H. Gazmuri 2005, SNA 2005).

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<sup>17</sup>Chile and Argentina had the earliest and most extensive labor movements in Latin America (Collier and Collier 1991: 96).

<sup>18</sup>According to Schneider (2004: 171): "The key dimension of organizational strength in the CPC was not its staff, which was always small, but rather its ability to reconcile differences and promote consensus."

In addition to strong organization, anti-statist ideology helped unite business across sectors on tax issues. Business in Chile champions the free-market, small-state, low-tax model implemented by Pinochet. The early influence of the University of Chicago economists in Chile laid the groundwork for widespread adherence to these views among businesspeople and economists. Beginning in the late 1960s, the Chicago School trained a core of Chilean economists associated with the Universidad Católica, known as the “Chicago Boys,” who adamantly sought converts among the business sector (Valdés 1995). The Chicago Boys played a key role in formulating economic policy under the dictatorship from 1975-82, which entailed radical market liberalization (Silva 1996: 97-130). Pinochet replaced the original Chicago Boys with more pragmatic neoliberal economists after the 1982 crisis, but the basic elements of the free-market, small-state economic model remained unchanged (Valdés 1995: 269-70, Silva 1996: 173-208). The dominant business groups of the 1990s and 2000s had emerged as the winners under the dictatorship’s economic model (Silva 1996: 195, Etchemendy 2004: 299, Luna 2006: 49) and therefore naturally supported that model and the underlying economic principles upon which it was based. As Silva (1998: 237) observes, “business leaders were convinced that in democracy their associations must play a highly visible watchdog role in defense of the economic policies of that era. Thus, it was incumbent on the CPC to express unity of purpose where any policy of general interest was concerned.”

Business leaders frequently expressed their ideological commitment to a small state and low taxation in interviews with the author. A former CPC president asserted: “business’s principle is that we do not want the state to grow,” (Ariztía, 2005, author’s interview). Likewise, a former president of the industrial association explained business’s opposition to tax increases as follows: “por el principio que el estado no aumenta su participación en la economía. ...los países que tienen menor carga tributaria crecen más rápido. ...eso era uno de nuestros argumentos que no subir los impuestos. ... además, el estado invierte mal, gasta mal, es ineficiente,” (Lizana 2005, author’s interview). In accord with the teachings of the Chicago School, taxes are viewed as distortionary and inefficient. Business often went so far as to frame taxation as confiscation of property (Silva 1996: 232; Urenda 2007, author’s interview); for example, business adamantly defended tax benefits as “acquired rights” (CChC 2005, author’s interview). Regarding a government proposal in 2000 to restrict the use of unlimited loss carry-forward, the CPC (2000: 11) asserted: “De esta forma, se expropia al empresario *un activo de su propiedad*... Al negar el proyecto la posibilidad de reconocer como activo la pérdida acumulada, se estará privando al contribuyente de *un derecho que tiene incorporado en su patrimonio*,” (emphasis added).

Partly because of these ideological views, even tax increases that exclusively affected a single sector could stimulate opposition from business as a whole, as occurred with the 2005 tax on the copper sector (see Chapter 4, Part 3). As a former General Manager of the CPC explained, the association tended to take positions against sectoral tax increases “por un tema de principios,” (Urenda 2005, author’s interview).

### **Partisan Linkages**

Business enjoyed strong partisan linkages along with informal ties to Chile’s two right parties, the *Unión Demócrata Independiente* (UDI) and *Renovación Nacional* (RN), which together form the *Alianza Por Chile* coalition. In this section, I present evidence of the core constituency relationship between business and the right, which other authors have also analyzed (Luna 2010, Pollack 1999). I then examine the balance of power in the Senate, where the right’s enduring though not invariant strength allowed it to effectively represent business interests.

### ***Business as a Core Constituency of the Right Parties***

The core constituency relationship between business and the right parties in Chile is evidenced first and foremost by programmatic convergence on economic policy and taxation in particular. In addition, the right parties receive high levels of support from business and upper-income individuals, and business has been an important actor in internal right party politics.

Since 1991, the Alianza has resisted increased taxation along with other economic reforms opposed by business.<sup>19</sup> The right parties' anti-tax positions are evident in the author's interviews with UDI and RN legislators as well as transcriptions of congressional debates. An UDI deputy, for example, asserted: "nosotros somos un partido que jamás ha estado a favor de subir los impuestos." Concertación policymakers also repeatedly emphasized the right's opposition to tax increases in interviews with the author. For example, former PS Senator Sergio Bitar (author's interview, 2006) exclaimed:

El sistema tributario para la derecha chilena es como la Virgen María, tú no la puedes tocar. Entonces hay una cosa ideológica absurda y cada vez que hacemos algunos cambios siempre amenazan con el infierno, de que van a escapar los capitales, de que va a reducirse la inversión, de que son todas medidas populistas, entonces hay siempre un discurso que se repite y lo hemos tenido que enfrentar.

Similarly, in the words of former president Lagos (author's interview, 2006): "Cuando llega el bolsillo, la derecha es muy duro... El bolsillo es muy difícil de tocar." Alianza, and especially UDI, defense of business interests is also evident in congressional voting records. According to Luna (2010, 22-3):

Available roll-call voting evidence portrays the UDI as the most systematic defender of market-oriented reforms introduced under the dictatorship. An analysis of the 2006-2008 period shows very high levels of internal discipline in 93% of the Alianza's registered congressional votes. However, each party's congressional voting record in the remaining 7% (encompassing approximately 90 bills) shows that the UDI is more responsive to business interests.

The UDI's defense of low taxation is rooted in its economically liberal, anti-statist ideological origins. The UDI was founded in 1983 by neoliberal Chicago-trained economists and technocrats from the dictatorship in conjunction with leaders of the *gremialista* movement, a Franco-inspired corporatist movement that emerged in the late 1960s with the goal of eradicating Marxism in Chile (Pollack 1999, Garretón 2000: 60-1, Luna 2006: 299). The UDI adhered to the most ideologically extreme version of neoliberalism associated with the Chicago Boys (Pollack 1999: 39, 116). While the *gremialistas* were originally conservatives rather than economic liberals, they ultimately embraced the free-market principles advocated by the Chicago Boys (Valdés 1995: 201, Etchemendy 2004: 314-316). In the words of Pollack (1999: 89), the UDI represented "those most loyal to the military regime's economic and political model." The UDI cultivated business support on the basis of its economic positions from the earliest days of democratization. According to a high-level UDI leader interviewed by Luna (2010: 22): "Our leaders convinced business elites that the party would be able to protect the market-oriented model introduced under Pinochet, aided by the special majority requirements that Jaime [Guzmán] included in the 1980 Constitution." Although the party began to distance itself from association with Pinochet in the late 1990s and 2000s, the UDI's economic positions remained largely unchanged.

Informal ties dating back to the dictatorship and shared class interests strengthened the relationship between the UDI and the business sector. Technocrats in Pinochet's government who became UDI members or sympathizers often served on the boards of business groups that benefited from privatization (Silva 1996, Silva 1997: 158-159, 161, Schamis 1999: 249-250, Pollack 1999: 45, Etchemendy 2004: 333). According to Schamis (1999: 250):

...key policymakers of the Pinochet government served on the boards and in the executive offices of large economic conglomerates before and after holding cabinet and central bank positions, leading to collusion between economic power and political power. Beneficial policy contexts allowed these firms to extract rents and consolidate positions of leadership, even monopoly ones, in their respective sectors... While Chile's return to democracy in 1990 and a center-left coalition in office ever since, the participation of policymakers of the military government on the boards of the largest firms in the country expanded, which suggests that the alliances forged during the long economic reform experiment were built to last.

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<sup>19</sup>Another prominent policy area in which the right defends business interests is labor legislation.

Similarly, Etchemendy (2004: 333) documents that privatizations after the 1982 crisis “were organized in ways that enabled the Pinochet associates (many of them close to the official party UDI) and managers to become owners through a series of Pos [public offers] biased in favor of regime insiders.”

The RN also embraced and defended the dictatorship’s neoliberal economic model, although the party’s origins were quite distinct from the UDI’s. The RN developed out of a heterogeneous amalgamation that included elements of Chile’s traditional pre-Pinochet agrarian right and nationalists who strongly supported the military regime, as well as young professionals and businessmen who supported the dictatorship’s economic policies but favored democratization (Boylan 1996: 25, Pollack 1999: 91-2, 111-12). Accordingly, the RN tended to hold less ideological positions than the UDI on economic issues. The RN’s less ideological stance in combination with bitter power struggles with the UDI (Pollack 1999) occasionally led some RN legislators to vote in favor of tax reforms proposed by the Concertación. However, tax increases and reforms to the inherited economic model more generally tended to elicit united Alianza opposition. As Garretón (2000: 66) observes, “The defense and preservation of the military regime’s socioeconomic model is the strongest common element linking rightist sectors...” Moreover, tax increases that won RN votes after 1990 were marginal.<sup>20</sup>

The right parties have enjoyed consistent support and funding from business. In the 1990s and early 2000s, business association leaders openly favored the Alianza. CPC presidents publicly endorsed Alianza presidential candidates, including Pinochet’s Finance Minister, Hernán Büchi, in 1989 (Silva 1998: 235, Pollack 1999) and UDI politician Joaquín Lavín in 1999 (ABIF 2005, author’s interview).<sup>21</sup> Outgoing CPC president Walter Riesco and his successor Ricardo Ariztía both openly proclaimed their identity as “*empresarios derechistas*” (and their loyalty to Pinochet) in the press in 2000.<sup>22</sup> And former CPC president (1990-1996) José Antonio Guzmán served as a member of the Alianza’s political committee in 2000 and maintained affiliations with both the UDI and the RN’s think tanks.<sup>23</sup> Although it is difficult to trace party financing, available evidence suggests that big business has disproportionately funded the right and especially the UDI (Luna 2010, 2006: 305, Pollack 1999:132).<sup>24</sup> First, the Alianza has spent substantially more on electoral campaigns than the Concertación. For example, the UDI and the RN together spent more than twice as much on campaigns for seats in the lower house than the Concertación in 2005, and private donations exceeded these parties’ public funding, by roughly a factor of four in the UDI’s case and a factor of two in the RN’s case (Luna 2010: 27). Likewise, by one estimate, the Lavín campaign outspent the Lagos campaign in 2000 by US \$30 million dollars (Angell and Pollack 2000: 364). Second, Luna (2010: 26) finds that compared to the Concertación, the UDI has received more donations in larger sums, which are likely to originate from businesspeople and wealthy individuals. Anecdotal evidence also suggests that business funds think tanks informally associated with the right parties, especially *Libertad y Desarrollo* (UDI) (Finance Ministry G 2005, author’s interview).

Along with support from business, the right receives significant electoral support from upper-income voters. In the 2000 presidential election, Lavín won between 62% and 71% of the vote in Santiago’s three highest-income districts (Angell and Pollack 2000: 370). Altman (2004) has also demonstrated that the right draws strong support from elites; he finds that the Alianza outperforms the Concertación in municipal and legislative elections in districts with very high scores on the UNDP’s Human Development Index. Luna (2006) argues that the UDI in particular wins support from upper-income voters on the basis of conservative policy positions, including opposition to taxation.<sup>25</sup> Eugenio

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<sup>20</sup>The 1990 reform represents a partial exception, see Section IV.

<sup>21</sup>*La Tercera*, March 26, 2000. The article notes Riesco’s “defensa acérrima del senador vitalicio Augusto Pinochet detenido en Londres y la abierta participación en la campaña de Joaquín Lavín.”

<sup>22</sup>*La Tercera*, Dec. 11, 2000: “La CPC nunca ha sido un partido político,” *El Mercurio*, Dec. 18, 2000: “El Pliego Empresaria.” Riesco in fact led a delegation of prominent business leaders to visit Pinochet during his detainment in London.

<sup>23</sup>*El Mercurio*, Nov 19, 2000: “Ocho meses después.”

<sup>24</sup>Luna (2006: 305) asserts that “UDI’s unique ability to secure and administer financial resources through its links to the private sector has provided the party an additional competitive advantage.”

<sup>25</sup>The UDI also does well in many low-income urban areas on the basis of non-programmatic appeals, generally involving small-scale clientelism (Luna 2006, Luna 2010). The UDI’s success in lower-income areas depends to a significant degree on support from upper-income constituents, as Luna (2006: 348) argues: “the successful development of UDI illustrates the emergence of an

González, an UDI activist who served as one of Lavin's campaign advisors for the 1999-2000 election, explained that in high income-districts of Santiago like Las Condes, Vitacura, Lo Barnechea, and La Reina: "...for the campaign, congress-members and mayors should get out in the media and talk about national themes, big themes, economic themes. Taxes are very important for those sectors, and addressing those issues is how you get a name for yourself," (interviewed by Luna 2006: 309).

As expected for a core constituency, business exerted significant influence over right party policy positions. On many occasions, the right took instruction on tax policy directly from organized business. This dynamic was particularly apparent with regard to tax reforms proposed by the Concertación that would have affected the copper sector (author's interviews: Eyzaguirre 2007, Finance Ministry G 2005). Eyzaguirre (author's interview 2007) referenced these reforms to illustrate what he described as the "extreme and sometimes irrational dependency of the right wing parties on the business sector."

In the 1990s, business also regularly intervened in right party politics, frequently imposing its preferred candidates (Pollack 1999; E. Guzmán 2005, author's interview). Thanks to this behavior, prominent business association leaders came to be known as the "*poderes fácticos*" (Pollack 1999: 178-9; E. Guzmán 2005, author's interview).<sup>26</sup> For example, the business sector ensured that Pinochet's former finance minister, Hernán Büchi, would be the Alianza candidate for the 1989 elections, despite the RN's preference for Sergio Jarpa, as described by Pollack (1999: 169):

The role of the economic conglomerates and the entrepreneurial sector was instrumental in the decision to adopt Büchi. In the run up to the 1989 elections, former finance minister Sergio de Castro was responsible for coordinating a group of individuals, installed in the recently privatized state companies, who used the vast financial resources available to them to fund the election campaign. These funds were funneled into a quasi-secret organization ... run by a group of powerful entrepreneurs linked to the economic groups. ... The fear that the political and economic system inherited from the Pinochet regime would collapse if the centre-left coalition emerged victorious led the economic right to support the hardest sector, UDI. They also vetoed Jarpa's candidacy at an early stage by withdrawing RN's funding until the party expressed its support for Büchi.

Similar dynamics occurred in the 1993 election: "Although the role of the economic right in the selection of the presidential candidate had not been as overbearing as in previous occasions, ... [in part] because none of the options presented to the convention were deemed to be unacceptable, their interference in the right's parliamentary campaign was as assiduous as ever," (Pollack 1999: 178). Business once again favored UDI; the major donors pressured the RN to accept the UDI's formula for dividing up candidacies for the House of Deputies and the Senate.<sup>27</sup> Business of course did not always get its way. In the 1997 parliamentary elections, for example, the UDI and the RN viscosly competed against each other despite the business sector's efforts to promote a united *Alianza* front (Pollack 1999: 181). Nevertheless, business was clearly a major player in right party politics.

### ***The Right's Strength in the Senate***

The right was able to effectively represent business interests thanks to its strength in the Senate. Although the right's advantage in the Senate declined after 1998, it retained enough seats to exert significant influence on sensitive issues.

Electoral rules that favored the right (Siavelis 2005) and authoritarian enclaves in the Constitution gave the right veto power after the transition to democracy. Pinochet appointed nine "institutional" senators in 1990, and he himself assumed a seat "for life." The right accordingly held a majority in the

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explicit dual representational strategy implemented by extracting economic resources (in exchange for ideological representation) from their "vote-poor/resource-rich constituents" to get the vote of their "vote-rich/resource-poor constituents."

<sup>26</sup>These business leaders included Juan Antonio Guzmán (CPC president from 1990-1996), Hernán Briones (SOFOPA president from 1991-1993) and Eugenio Heiremans (another former SOFAFA president).

<sup>27</sup>The RN's moderate leader publicly depicted the business sector as a "poder en la sombra," which irritated entrepreneurs to the extent that they withheld funding for the right (Pollack 1999: 178).

Senate from 1990 to 1997, despite the fact that the Concertación won the majority of elected seats. As Silva (1998: 243) observes, authoritarian enclaves “place business and its political party allies in a superior, privileged position in the policy-making process...”

The right’s veto power eroded after 1998 when the terms of Pinochet’s designated senators ended. In addition, Pinochet’s detention in London that same year on charges of human rights violations in practice terminated his own senate career. The Constitution authorized the presiding Concertación administration to select two new institutional senators to replace those appointed by Pinochet; the Supreme Court and the Armed Forces named the rest. The two Supreme Court appointees and two of the four Armed Forces appointees held more moderate views than their predecessors on economic issues, as the President of the Senate (1998-2004) recalled:

La derecha tenía siempre éxito con los senadores institucionales cuando se trataban temas más bien sensibles al mundo militar, derechos humanos, todo ese tipo de cosas, pero ... estos senadores no tenían un compromiso claro del punto de vista económico, gente toda ella de origen de clase media, gente que ha sido más bien presidente de la corte suprema, o el otro era vice comandante en jefe del ejército, entonces habían 2 o 3 senadores que eran muy sensibles a entender al gobierno de la Concertación. (Zaldívar 2007, author’s interview)

From 1999-2005, the right and the Concertación were nearly tied in the senate; the four “swing voters” among the new designated senators determined which side prevailed (Figure 2.4).

Although this new balance of power gave Lagos more room to maneuver than previous Concertación governments, on sensitive issues like corporate taxation, winning over the four swing senators was a major challenge, and the right proved a formidable opposition force. The former President and his Finance Minister asserted that they lacked the votes necessary to advance further on this front (author’s interviews: Lagos 2006, Eyzaguirre 2007). Furthermore, Mario Marcel, the Lagos administration’s Budget Director, in effect attributed lack of progress on tax reform to instrumental power arising from the right’s strength in congress, rather than structural power:

— *El sector privado siempre dice que cualquier proyecto tributario va a desincentivar la inversión. ¿Cuánto peso tiene ese argumento? No mucho... En el fondo, la razón por la cual luego de ese aumento de la carga tributaria en el 90 no ha habido aumentos posteriores, más que ... por el riesgo de afectar las inversiones, ha tenido que ver con que la Concertación nunca ha tenido los votos para aprobar modificaciones tributarias sola, siempre ha requerido acuerdo de la oposición.*

**Figure 2.4: Correlation of forces in the Senate, 1998-2005**

Political block	Senators 1998-2002 (49 seats)	Senators 2002-2005 (48 seats)
<b>Concertación</b>	<b>24</b>	<b>23</b>
PS	4	5
PPD	2	2
PDC	16	13
Concertación-appointed or aligned designated senators	3	3
<b>Alianza</b>	<b>20</b>	<b>20</b>
UDI	9	11
RN	8	7
Alianza-aligned designated senators (Armed Forces appointments)	3 (Canesa, Martínez, Pinochet until 2000)	2 (Canesa, Martínez)
<b>Designated Senator Swing Votes</b>	<b>4</b>	<b>4</b>
Supreme Court Appointees	2 (Aburto, Zurita)	2 (Aburto, Zurita)
Armed Forces Appointees	2 (Vega, Cordero)	2 (Vega, Cordero)
<b>Independents</b>	<b>1</b> (Errazuriz: independent-right)	<b>1</b> (Avila: PRSD)

## Government-Business Concertation

Concertation with business, namely, regular government consultation and cooperation with the CPC and sectoral business associations, provides a third source of instrumental power. While partisan linkages provided business instrumental power in congress, concertation afforded instrumental power with respect to the executive branch. Concertation is important not simply because easy access to policymakers allowed business to directly communicate its interests and lobby for concessions, but because this informally institutionalized pattern of government-business relations created incentives for policymakers to avoid conflict with business over taxation.

During the transition to democracy, the *Concertación* cultivated business confidence by consulting with the CPC and its member associations on economic reforms, a practice established under Pinochet in the aftermath of the 1982 crisis (Silva 1996: 231, Schneider 2004). Accordingly, “whenever the new administration wished to introduce changes in the pragmatic neoliberal model founded under Pinochet ...top policymakers regularly consulted and negotiated with the leadership of business peak associations ...from the policy formulation stage on down,” (Silva 1997: 173). *Concertación* leaders felt these measures were critical to ensure investment and growth during a time of uncertainty, given that business openly supported Pinochet throughout the transition (Silva 1997: 178). As Silva (1997: 177) explains: “For capitalists, the [*Concertación*] policymakers belonged to a political bloc tied to a statist past who had to prove their capacity to maintain a good business climate. Business leaders were on their guard, ready to challenge deviance and defend the gains made during the dictatorship.” Concertation helped quell business’s fears, and investment surged during the 1990s (Silva 1997: 177).

Credible threats of disinvestment subsided after consolidation of neoliberalism and democracy by the late 1990s. However, consultation on all facets of economic policy and economic governance remained a defining characteristic of government-business relations,<sup>28</sup> even in the absence of the conditions that originally led the coalition to embrace this model.

Many authors have observed that concertation in Chile helps business achieve influence by providing easy access to top-level policymakers (Silva 1997: 176-7, Teichman 2001: 92). More importantly, however, I argue that Concertation creates incentives for government policymakers to avoid conflict with business. Collaboration with business on a wide range of policy areas beyond taxation is valued in part because of excellent macroeconomic outcomes associated with this model.<sup>29</sup> For example, business-government collaboration led to a series of reforms designed to promote growth that were championed by Lagos and his successor, Bachelet, as important advances. The reforms grew out of proposals that the industrial association, SOFOFA, presented to the government at the end of 2001, known as the *Agenda Pro-Crecimiento*. The executive branch worked closely with SOFOFA while formulating the reform proposals; the Finance Ministry convened numerous working groups with business association leaders and technical advisors in the months after SOFOFA proposed the *Agenda*.<sup>30</sup> Lagos expressed his enthusiasm regarding this collaboration with the private sector when the joint proposals were announced in March 2002:

...este aporte que se hace hoy, ... es una demostración de que estamos haciendo bien las cosas para tener un más rápido crecimiento para Chile, que es la gran tarea de los próximos años. Estamos aquí ante una iniciativa de una gran importancia. No sólo por el aporte que se hace a lo que es la agenda del gobierno en los próximos cuatro años, sino porque aquí hay un esfuerzo común del sector público y del sector privado para mejorar la situación de chilenas y chilenos, un país más eficiente, con reglas más claras en distintos sectores, un país donde se pueden tomar más iniciativas. Y en este sentido, la Agenda Procrecimiento es un hito que plasma este potencial de encuentro y de entendimiento. ...muchas gracias por esta Agenda Procrecimiento, gracias por

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<sup>28</sup>Schneider (2004: 152) refers to this system as “cooperative capitalism.”

<sup>29</sup>This interpretation builds on Schneider (2004: 210).

<sup>30</sup>*El Diario*, Jan. 28, 2002: “Agenda Pro Crecimiento Termina su Elaboración en Medio de Elogios.”

lo que se ha planteado.<sup>31</sup>

The more than twenty reforms that were ultimately approved included measures to promote small and micro-business, measures to strengthen capital markets and promote venture capital, reforms to modernize the state, and double tax treaties.<sup>32</sup>

Further, business support and collaboration on issues like macroeconomic policy can be politically important for Concertación finance ministers, who have all adhered to orthodox economic principles. Finance ministers have come under significant pressure from the coalition's left wing to deviate further from the neoliberal economic model than they feel prudent, as occurred during the 2000-2001 recession. Subsequent collaboration with business allowed the Finance Minister to counterbalance pressures from within the Concertación:

I did have a *lot* of opposition, because the ones that were saying that the model didn't work ... and ask[ing] for more state involvement were very vocal ... The new generation of business leaders... saw that Lagos and I were macro-economically responsible, that [we] would defy the ones within our sector that wanted to be more Keynesian, and that at the end of the day when it comes to taxes we were sensible ... In economic policy at the end [there] was a big coalition of the center, ... and the very ideological in both extremes were isolated. From the political point of view that was a very important step. (Eyzaguirre 2007, author's interview)<sup>33</sup>

This same dynamic whereby Finance Ministers have sought business support on macroeconomic policies in the context of opposition from the Concertación's left-wing continued under the Bachelet administration.

Given the perceived importance of collaboration with business, conflict over taxes could be costly for the government. Tax increases threatened business's core interests—profits—and its ideological views. Furthermore, business correctly perceives taxation as a redistributive tool—one of the few available to a center-left government that embraces market economics. As Eyzaguirre (author's interview, 2007) explained: "The big entrepreneurs understand ... that once we have agreed on a market economy, an open economy, the name of the game is tax burden. So whatever points to increas[ing] the tax burden that in Chile is very low, would immediately unleash their total opposition." Consequently, as Eyzaguirre (author's interview, 2007) succinctly remarked: "Taxation is the name of the war." Conflict over taxes has the potential to jeopardize support from the business sector during critical periods or to disrupt government-business interactions on other issues.

Concertation served as a valuable relationship-based source of instrumental power in addition to partisan linkages. While partisan linkages were often the most important source of business power, the Alianza, like all right parties, occasionally deviated from the preferences of its core constituency in order to appeal to a broader electorate (Gibson 1992). However, concertation helped to reduce the possibility that the executive would propose significant tax increases when the right was most vulnerable to electoral pressure.

### **Other Sources of Instrumental Power**

Other sources of instrumental power in Chile beyond cohesion, partisan linkages, and government-business concertation were either absent or of secondary importance. Business did not enjoy recruitment into government or strong informal ties to executive policymakers under Concertación governments. In contrast to earlier periods when cabinet members were often drawn from business circles (Silva 1998:

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<sup>31</sup>“Intervención de S.E. el Presidente de la República, D. Ricardo Lagos Escobar, Al Dar A Conocer Resultados de Trabajos de las Comisiones Público-Privadas en el Marco de la Agenda ProCrecimiento,” Santiago, March 15, 2002. [www.sofofa.cl](http://www.sofofa.cl)

<sup>32</sup>SOFOFA, Memoria Annual, 2004-2005. [www.sofofa.cl](http://www.sofofa.cl)

<sup>33</sup>Support from the CPC under the leadership of Juan Claro also helped to shore up the Lagos administration in 2003 after allegations that the Ministerio de Obras Publicas had been diverting state funds for political campaigns broke in the press (the MOP-GATE scandal) (author's interviews: CChC 2006, Beyer 2007).



220),<sup>34</sup> after the 1990 transition, the Finance Ministry and other agencies were staffed with technocrats loyal to the Concertación (Silva 1996: 231, Silva 1997: 178, Teichman 2001: 90). In the early 1990s, many ministers were drawn from the *Corporación de Estudios para Latinoamérica* (CIEPLAN), a think tank founded by Concertación economists who criticized the dictatorship's policies. For example, President Aylwin's (1990-1994) Finance Minister, Alejandro Foxley, was a prominent CIEPLAN economist. Foxley's successor, Eduardo Aninat, was another longtime Christian Democrat with a Ph.D. in economics from Harvard and experience in international financial institutions (World Bank and Inter-American Development Bank). Subsequent Finance Ministers were also US-trained economists without ties to the Chilean business sector. President Lagos' Finance Minister, Nicolás Eyzaguirre, was a Concertación economist trained at Harvard with experience at the IMF. And President Bachelet's Finance Minister, economist Andrés Velasco, was a professor at the Kennedy School of Government prior to his engagement in the 2005 electoral campaign.

Turning from relationships with decision-makers to resources, business in Chile did possess significant technical expertise. Sectoral peak associations maintained permanent technical advisors among their staff and lent these advisors' services to the CPC as needed. Business associations' technical advisors participated in meetings with executive policymakers and regularly accompanied business leaders when invited to congressional committee meetings. Moreover, technical expertise was a prerequisite for government consultation with organized business.<sup>35</sup> Finance Ministry officials, who were all highly trained economists, probably would have perceived few benefits to collaborating with business associations on economic policy had business representatives lacked technical expertise.

However, technical expertise as a source of instrumental power in and of itself was secondary in importance to cohesion, partisan linkages, and government-business concertation. Finance Ministry officials had sufficient expertise of their own to independently evaluate business's arguments, and they were quite attuned to the possibility that technical language served purely to legitimate business demands with little actual technical merit. This perspective differs from Silva (1997: 176), who emphasizes that: "The exchange of information on the basis of technical evaluations facilitated accommodation" between business and executive branch policymakers.<sup>36</sup> While policymakers agreed with technical issues raised by business in some cases, it is important to note that modifications to tax proposals resulting from government-business dialog were often purely political concessions.<sup>37</sup>

### **Restricting the Agenda: Mechanisms and Case Studies**

Instrumental power influenced tax policy in Chile by restricting the executive's agenda. The Finance Ministry anticipated that tax increases would stimulate costly, coordinated opposition from business and the right. When it appeared that not enough votes to pass a reform could be secured from

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<sup>34</sup>From the late 1930s through the 1950s, business elites were given ministerial positions and membership on boards of state institutions like the Central Bank and the Development Corporation; according to Silva (1998: 220), "This pattern was institutionalized and persisted largely unbroken until the 1960s." After a period of exclusion corresponding to the radical phase of neoliberal reform (Silva 1996), business enjoyed renewed ties to Pinochet regime policymakers, and even recruitment into government, following the 1982 crisis: "Increased access to and influence over the policy-making process rested primarily on a shift in the background of key economic ministers. In stark contrast to the earlier technocratic Chicago Boys, beginning in early 1984, most economic ministers were leaders of organized business..." (Silva 1997: 232).

<sup>35</sup>Silva (1998: 241) implies a similar point: "It helps that both government officials and business leaders... have the technical capacity to participate in policy design."

<sup>36</sup>My findings regarding taxation also contrast with Bull (2008: 219), who argues that in a different policy area, trade treaties with Asia, government officials relied heavily on advice from business associations, given their own lack of expertise on this region.

<sup>37</sup>For example, although a construction sector informant maintained that his association's technical arguments had convinced Finance Ministry officials not to eliminate a tax credit for the construction sector in 1998 (Bruna 2005, author's interview), former Finance Minister Aninat (author's interview 2007) and former tax agency director Javier Etcheverry (author's interview 2005) asserted that the exemption was not technically justified; they agreed not to eliminate it as part of the agreement reached with business and the right that was necessary for securing approval of the larger tax reform package in the Senate. Business's supposedly technical arguments against a 2008 government proposal to restrict a VAT exemption that benefited the construction sector also failed to convince government policymakers, although these arguments may have helped business win concessions in congress (Chapter 4, Part 5).

among the institutional swing senators and/or the Alianza senators, the executive would dismiss that reform as infeasible and strike it from the agenda. Meanwhile, concertation with business associations created additional incentives to set aside sensitive tax issues in order to avoid conflict. This section illustrates these mechanisms by examining the decision-making and legislative processes surrounding four tax reforms proposed by the Lagos administration.

### ***The 2000 Anti-Evasion Reform***

Corporate tax increases remained off the agenda in 2000 when the Lagos administration assumed power thanks to anticipated rejection from business and the right. These actors were especially disinclined to accept tax increases at this time, given business hostility toward the first socialist administration since the 1973 coup, and the right's belligerence following its candidate's strong performance in the 1999 presidential election (Silva 2000, see also Chapter 4, Part 1). Consequently, although the former Finance Minister observed that "the big money is in direct taxes" (Eyzaguirre 2007, author's interview), the administration decided to raise revenue for expanded social spending by fighting *indirect* tax evasion in order to minimize conflict with business and the right and to secure the votes needed in Congress. As Eyzaguirre (author's interview, 2007) recounted, reforms designed to address the problem of low income tax revenue associated with the gap between the corporate tax and the top personal income tax rates were deemed infeasible:

We didn't even try to pursue some other more important reforms that we discussed... [because] we say that there was no water in the pool. ... We were trying to make it more difficult for consultants or professionals to constitute societies in order to [avoid income taxes].... but ... we said we are not going to have political capital for that.

The political process surrounding the 2000 Anti-Evasion Reform illustrates the dynamics of the "tax war" described by Eyzaguirre and helps to explain why the Lagos administration was so reluctant to contemplate more significant tax increases. Business and the right aggressively opposed the reform even though it focused on indirect taxes and contained only marginal tax increases associated with closing loopholes. Cross-sectoral unity and partisan linkages allowed business and the right to consolidate into a single actor and strengthened their bargaining position. According to the former Tax Agency Director, who helped negotiate the reform:

The right and the business leaders... it was the same thing. ... I didn't know if I should negotiate with the senator leader of the opposition or with the president of the big enterprises. Sometimes I had to negotiate with both, because they work together. ... Sometimes they were both in the same meetings saying the same things. ... they coordinated among themselves, and it was public, it was not hidden. (Etcheverry 2005, author's interview)

Similarly, when asked if they had noticed any differences between the positions of the business associations and the Alianza, Eyzaguirre (2007, author's interview) replied: "A block. At that time they were a block," and Lagos (2006, author's interview) asserted: "No, fue muy monolítica." Although the administration ultimately secured its primary objectives, passing the reform required a major expenditure of political capital (author's interviews: Etcheverry 2005, Lagos 2006, Eyzaguirre 2007); the reform languished in congress for almost a year while the executive negotiated with business and the right. This experience discouraged the administration from proposing more significant tax initiatives later in his term. As Lagos (author's interview 2006) explained:

When you are in government, what is important is to deliver. ... You have to count your chips, how many you have to fight. If I get involved in doing a profound tax reform, I lose two, three years arguing about the tax system, and there is no *AUGE* [health care reform], no education [reform]... there is nothing.<sup>38</sup>

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<sup>38</sup>Similarly, Foxley (2005, author's interview) asserted with regard to increasing the corporate tax: "es un tema de economía política. Cuántos conflictos quieres tu durante durante un periodo de gobierno, y cuales de los conflictos escoges."

### *The 2001 Corporate Tax Increase*

The 2001 corporate tax increase further illustrates how instrumental power restricted the Lagos administration's reform agenda. This marginal two-percentage point increase left the corporate tax far below the Finance Minister's preferred point and did not raise additional revenue, since it was combined with a personal income tax cut. Nevertheless, the reform required complex negotiations and elicited significant opposition from business and the right. This case illustrates the extent to which business was able to influence the agenda, as well as the fact that influence after a reform had been proposed tended to be much less significant by comparison.

Increasing the corporate tax was not on the Lagos administration's agenda in 2001 (author's interviews: Foxley 2005, Finance Ministry B 2005). As described above, major political capital had already been spent to secure passage of the Anti-Evasion Reform in June, and the administration did not wish to provoke additional conflict with business and the right. Instead, the corporate tax increase was advocated by the PDC and spearheaded by former Finance Minister Foxley, then president of the Senate Finance Committee. Foxley undertook the political challenge of negotiating with business, the right, and the Concertación parties to devise an acceptable reform proposal, with the Finance Minister's assurance that the executive, which holds exclusive initiative on taxation according to the Constitution, would initiate the reform if sufficient support could be secured in the senate.

Reducing the top income tax rate was critical for making the corporate tax increase politically feasible. As Lagos (2006, author's interview) recalled: "queríamos aumentar el impuesto de primera categoría, pero ...había que entregar un candy" in order to placate business and the right. Accordingly, Foxley and his collaborators proposed reducing the top marginal income tax rate from 45% to 35% in exchange for increasing the corporate tax from 15% to 18%. Foxley (2005, author's interview) framed the reform as a tax cut for the "middle-class," rather than a corporate tax increase. His argument proceeded as follows:

Los de arriba eluden, con las sociedades, los de abajo son exentos. Y los sectores medios que son normalmente empleados de una empresa o del gobierno, les descuentan el pago del impuesto a los sueldos cada mes. Por lo tanto, no puedan ni evadir ni eludir, y terminan pagando el impuesto ellos, nadie mas que ellos.

Meanwhile, the corporate tax increase was justified as necessary to finance the personal income tax cut. The Lagos administration made clear that it would not accept a reform that reduced tax revenue, arguing that neither social spending nor fiscal discipline could be sacrificed.

As the administration had anticipated, constructing an agreement with business and the right proved difficult. Foxley (author's interview, 2005) described the process as "un lío político" and asserted that the negotiations were "muy complejo con mucho conflicto." While business and the right embraced the personal income tax cuts, they opposed the corporate tax increase.<sup>39</sup> According to Foxley, "se subió el impuesto a las empresas con gran queja de los empresarios y de algunos de los parlamentarios de la derecha." Business and the right ultimately agreed to accept only a two point corporate tax increase rather than a three point increase; to maintain revenue-neutrality, the top personal income tax rate was cut to 40% instead of 35%.<sup>40</sup>

The Senate record suggests that a more ambitious corporate tax increase would have failed. The 2001 reform passed with ample support during the first vote on the package as a whole (*debate en*

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<sup>39</sup>On business opposition to the corporate tax increase, see CPC 2001b, *La Tercera*, June 29, and July 5, 2001, *El Mercurio*, July 21, 2001, and business informants: Ariztía 2005, ABIF 2006, Fuenzalida 2005, F. Gazmuri 2005, Mining Sector B 2005. Business assumed the bargaining position of accepting at most an increase of 1 percentage point. On business support for reducing the top individual income tax rate, see CPC 2001b and numerous business informants: Echeverría 2005, Lizana 2005, Morandé 2005, F. Gazmuri 2005, J.A. Guzmán 2005, SNA 2005. A number of these informants agreed that the gap between the corporate and top personal income tax rates promoted evasion and avoidance. They preferred to correct the problem by radically reducing the individual income tax rates; a few were willing to accept in exchange a corporate tax of no more than 20%.

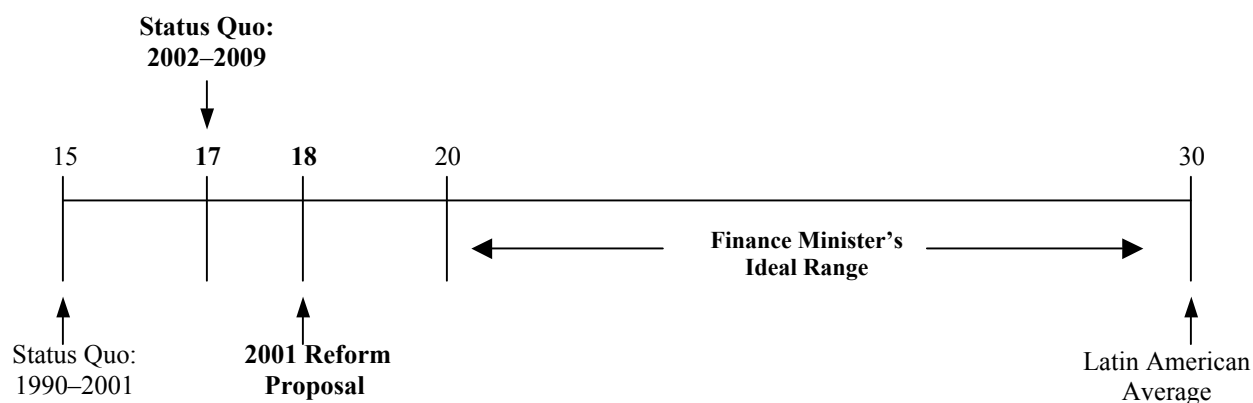
<sup>40</sup>Meanwhile, the left wing of the Concertación, particularly the Socialists, opposed the personal income tax cut on the grounds that it was regressive (J. Gazmuri 2005, author's interview; Marcel 2006, author's interview). Strong party discipline and loyalty to Lagos, as well as the Finance Ministry's agreement to increase the minimum non-taxable income level in order to benefit the lower-income end of taxpayers, ensured the Socialists' votes in favor of the reform.

general); five RN senators, two institutional swing-senators, and one of the right-aligned institutional senators voted in favor while the UDI mostly abstained (one voted no). However, during the debate on the individual articles of the reform (*debate en particular*), the UDI presented a motion to eliminate the corporate tax increase from the package. Although the motion was defeated 26 to 12, two RN senators voted with the UDI to reject the corporate tax increase, and the four RN senators who voted with the Concertación expressed their preference for a one-point rather than a two-point corporate tax increase. One of the institutional swing-senators voted with the UDI, and the remaining two institutional swing-senators who were usually inclined to vote with the government instead abstained.<sup>41</sup>

The 2001 corporate tax increase illustrates the important point that business influence after a proposal had been drafted tended to be insignificant compared to influence over the government’s reform agenda, an earlier and more critical stage in the policy process. The Finance Minister believed the corporate tax rate should be increased “notoriously [*sic.*],” presumably above 20%—the Concertación’s goal for the 1990 reform—and closer to 30%, the Latin American average. However, the proposed reform entailed increasing the rate to only 18%. The concession won by business and their right-party allies during negotiations before the bill entered congress—reducing the proposed new corporate tax rate from 18% to 17%—was trivial compared to business’s ability to prevent much more significant reforms from even being discussed.<sup>42</sup>

The implicit threat of united business-right opposition thus shifted the range of tax rates under debate significantly toward business’s preferences (Figure 2.5),<sup>43</sup> removing important reforms from the agenda that government leaders may otherwise have sought to enact. This analysis agrees with Hacker and Pierson’s (2002: 284) observation that “the most significant aspect of influence involves moving the decision-making agenda toward an actor’s preferred end of the spectrum.”

**Figure 2.5: Corporate Tax Policy Space (tax rates, percent)**



This finding regarding the importance of business’s influence over the agenda contrasts with earlier work by Silva and illustrates that business in Chile may be even more powerful than previously recognized. Silva (1997: 176-77) emphasizes business’s ability to win modifications to drafted reform proposals based on easy access to executive-branch policymakers arising from government-business concertation:

<sup>41</sup>The second such institutional swing voter did not attend the session.

<sup>42</sup>The Finance Minister did not wish to abruptly increase the corporate tax rate from 15% to some value above 20%. Instead, he advocated gradual increases. However, gradual increases leading up to a much higher corporate tax rate after some period of adjustment could have been incorporated in the 2001 reform. The 2001 reform in fact phased in the two-point tax increase over a period of several years. Additional gradual tax increases could also have been proposed as separate initiatives later in Lagos’ term. Thanks to business’s instrumental power, however, these alternatives were not pursued.

<sup>43</sup>When examining Figure 2.5, note that although business preferred a rate even lower than 15%, the best the right could do was to preserve the status quo, since exclusive executive initiative prevents legislators from modifying or initiating tax proposals.

...top policymakers set the agenda for incremental changes. After their technical commissions drew up draft legislation, it was circulated to the appropriate peak association. ...Policymakers and business leaders then negotiated on the basis of those reports. ...In virtually every interview, business leaders acknowledged that this system allowed them to alter proposed legislation in ways that favored their interests.<sup>44</sup>

However, focusing on alterations to proposed legislation rather than the agenda-formulation process would lead one to conclude that business influence was less significant than in fact was the case, as evidenced by the forgoing discussion of the 2001 corporate tax reform. In fact, business was so powerful that in most cases it did not need to mobilize to defeat reforms it opposed; the mere threat of business-right mobilization sufficed to keep significant tax increases off the agenda.

Analyzing agenda formulation in Chile is imperative because the most critical political decisions are made before a proposal is drafted. As others have observed (Luna 2006), reforms that are not deemed likely to pass in Congress are never initiated. A Finance Ministry informant explained this logic as follows:

Primero se conversa con parlamentarios que son mas crecanos a los temas nuestros... con ciertos empresarios... Si nosotros hacemos un anuncio, es porque hemos evaluado que tenemos una chance importante político de sacarlo adelante... en Hacienda no hacemos anuncios si no lo hemos pensado bien en términos de factibilidad política. Hay un costo de reputación muy grande en anunciar cosa que luego no se puede implementar políticamente el en parlamento. (Finance Ministry B 2005, author's interview)

Analyzing open policy debates may not even be sufficient to assess the extent of business-right influence. Some reforms are known to be so controversial or so politically problematic that the executive does not bother to test the waters; accordingly, actors not privy to inner circles within the executive branch may be unaware of leaders' true policy preferences. Interviews with top decision-makers can be critical for ascertaining what reforms leaders wished to implement independently of perceived political constraints, which is in turn critical for assessing the full extent of business influence. In other words, as Hacker and Pierson (2002: 283) emphasize, we must distinguish between "induced" or "strategic" preferences and actual preferences.

### ***Corporate Tax Non-Reform, 2003 and 2005***

Business's strong instrumental power kept corporate tax increases off the agenda throughout the remainder of Lagos' term, despite the fact that the administration faced additional revenue needs in the aftermath of the Anti-Evasion Reform. In 2003, tariff reductions included in trade treaties signed with the US and Europe made increasing other taxes imperative for financing expanded social spending on health care and anti-poverty programs without endangering fiscal discipline. The Finance Ministry proposed to compensate the revenue lost to tariff reductions by increasing the VAT (Chapter 4, Part 2), despite objections from within the Concertación, rather than fighting with business and the right over direct taxes. Lagos (author's interview 2006) explained this decision as follows:

No tenía ninguna otra posibilidad de aumentar ningún otro impuesto. Porque iba a ser rechazado. ... la Concertación no quería aumentar el IVA. Querían impuesto a las personas, o el impuesto a las empresas. Yo le dije, para qué me pidan cosas que son imposibles? Este impuesto no va a ser realidad porque la derecha en el Senado me lo va a rechazar.

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<sup>44</sup>Elsewhere he recounts: "...the leaders of top business peak association confirmed that easy access to the executive branch bolstered their confidence in the Concertación's assertion that it intended to adhere to the main tenets of pragmatic neoliberalism. They also acknowledged that this system allowed them to alter proposed legislation in ways that favored their interests," (Silva 1996: 235).

During the 2005 electoral campaign, the Lagos administration briefly considered proposing another corporate tax increase, but the idea was ultimately discarded. In May 2005, the issue of inequality assumed a prominent role in the presidential campaign. The Alianza candidate, Lavín, accused the Concertación of having failed to reduce inequality during its fifteen years in power. The Lagos administration subsequently sent a proposal to congress to eliminate a notorious tax benefit inherited from the 1980s that amounted to a subsidy for wealthy stock-owners (Chapter 4, Part 4). Although UDI and the RN had consistently defended the tax benefit since 1990, they now felt compelled to vote in favor of the proposal to protect their candidate's credibility and electoral prospects.

The right's unexpected support for equity-enhancing tax reform in the context of the presidential campaign created a potential opportunity for further advances, and initiating a proposal to increase the corporate tax was discussed informally—and privately—at the highest level. Top leaders in the administration recognized the uniqueness of the political conjuncture: “The opposition whenever the elections are coming get very soft-hearted, that is precisely the moment where you can do these things,” (Eyzaguirre 2007, author's interview). Meanwhile, many Concertación legislators pressed for the administration to take advantage of the opportunity by proposing additional reforms. As Eyzaguirre (2007, author's interview) recalled, “At some points they [the right] were so incredibly cynical or hypocritical when they said we haven't done anything for income distribution, that we were tempted to send that bill.” However, the administration ultimately decided against any further initiatives.

This episode of corporate tax non-reform illustrates the importance of business's multiple sources of power. In this case, partisan linkages alone might not have been sufficient to protect business interests on corporate taxation. Given the salience of inequality in the presidential campaign, the right might conceivably have deviated from the preferences of its core constituency for the sake of appealing to a broader electorate. However, government-business concertation bolstered instrumental power. The administration's reluctance to incur further conflict with business and the right helped to remove corporate tax reform and other progressive initiatives from the agenda in 2005 (Finance Ministry B 2005, author's interview). Avoiding deterioration of Concertación-business relations during the administration's last months in office so that Bachelet would be able to work productively with business associations on economic policy initiatives and would not have to face problems similar to those Lagos experienced at the outset of his term probably contributed to the administration's decision not to initiate any additional tax reforms. The mild royalty on copper legislated the previous year had entailed a major battle with business (Chapter 4, Part 3); eliminating the tax exemption for stock-owners antagonized business as well. In this context, and given other priorities, an informant recounted that the administration: “consideró que ya tenía conflictos en muchos frentes. ...fue un análisis general, de cuantos conflictos estoy enfrentando, cuantos soy capaz de confrontar, al mismo tiempo en una época de elecciones, y consideró que quizás no era el momento para agregar otro área de batalla,” (Finance Ministry A 2005, author's interview).

This case provides a remarkable illustration of business power, given that sending a corporate tax increase to congress may actually have been electorally advantageous for the Concertación in 2005. Although opinions on this point differed within the Concertación, with some asserting that it was best to forgo any discussion of taxes (author's interviews: Finance Ministry B 2005, A. Velasco 2005), the former Finance Minister himself maintained that proposing a corporate tax increase would have put the right on the defensive (Eyzaguirre 2007, author's interview). Had the right prioritized its core constituency's interests by voting against a corporate tax increase, the Concertación could have demonstrated its opponents' resistance to redistributive reforms, undermining Lavín's credibility just months before the election. Sending proposals to Congress that the right opposed had proved a successful electoral strategy in the past. The right attributed its loss to Lagos partly to its legislators' votes against the Frei administration's labor reform in 1999.<sup>45</sup> Nevertheless, the desire to contain conflict with business

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<sup>45</sup>*El Mercurio*, May 12, 2005: “Joaquín Lavín y las fórmulas para enfrentar la desigualdad,” *El Mercurio*, May 3, 2005: “Nuevo Escenario de Campaña.”

and the sense that another battle with business and the right over taxes would prove unmanageable prevailed.

#### **IV. The 1990 Reform in Retrospect: A Unique Business-Right Compromise**

Based on the case of the 1990 tax reform, Weyland (1997) characterizes Chile as a success story for progressive taxation and argues that business cohesion facilitates redistribution. In contrast, I maintain that the 1990 reform represented a modest if important advance that essentially returned tax revenue to the status quo of the mid-1980s, an assessment that is consistent with earlier research by Boylan (1996) and Silva (1996). Moreover, I argue that original design and the outcome of the 1990 reform proposal are consistent with expectations based on strong business power and identification of cohesion as a source of instrumental power. In fact, the 1990 tax reform is best understood as a limited, one-time business-RN compromise during an unusual moment—the transition to democracy. Thereafter, business and the RN resumed intransigent stances on taxation, and cohesion helped business prevent subsequent tax increases.

Increasing the corporate tax was the central component of a tax reform package proposed by the Awlyin administration shortly after assuming office in 1990. First, the administration sought to increase the very low corporate tax rate from 10% to 20% (Foxley 2005, author's interview). Second, the administration sought to apply the corporate tax to accrued profits, rather than only distributed profits. At that time, retained profits (profits reinvested in the firm) were not taxed at all. Corporate tax reform, along with adjustments to the personal income tax brackets to enhance progressivity (Boylan 1996: 12, Marcel 1997: 52) and a number of measures to close direct-tax loopholes,<sup>46</sup> aimed to raise additional tax revenue amounting to 3% of GDP (Boylan 1996: 14).

Although the reform would constitute a substantial tax increase compared to the prevailing status quo, the proposal was actually quite moderate. First, taxing accrued profits rather than only distributed profits merely reversed Pinochet's eleventh hour tax give-away to the business sector; the dictatorship switched the corporate tax base from accrued to distributed profits in January 1989 (Marfán 1998: 550-1). Corporate tax collections in practice dropped to zero (Marcel 1997: 36), given the large percentage of profits that are reinvested in Chile, and total income tax collections fell by a full percentage point of GDP (Marfán 1998: 551). Second, as Boylan (1996) observes, 20% was still a very low corporate tax rate by regional standards at that time; the average maximum corporate tax rate in Latin America excluding Chile was 34.5% in 1992 (Gomez-Sabaini 2005: 35). Furthermore, although Concertación leaders wished to raise the rate to 20%, the government merely proposed that the corporate tax be increased to within the range of 15% to 20%, signaling willingness to accept the lower corporate tax rate.

The moderate design of the proposal and the Concertación's express willingness to compromise reflected the new government's recognition of business's strong instrumental power as well as structural power. As previously discussed, the right could veto legislation in congress thanks to the presence of Pinochet's designated senators, business was highly cohesive, and the Concertación was intent on minimizing conflict with business in the context of uncertainty surrounding the transition. As Boylan (1996: 10) notes, "Because of the propertied classes' close and protective relationship with the armed forces, assuaging bourgeois interests becomes a central means of reducing political risk during the transition," a point established in the democratic transition literature. In addition, the Concertación sought to demonstrate its commitment to the neoliberal model to a dubious business sector, which might have disinvested if the new government's policies appeared to revert to the statist tendencies of the past (Foxley 2005, author's interview).

Business proved willing to accept increased taxation in 1990 although it had the ability to resist for two reasons. First, in the aftermath of Pinochet's defeat, key business leaders decided that compromise on taxation with the new government was strategically opportune. A moderate tax increase to fund social

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<sup>46</sup>For example, the Concertación sought to tax the largest contributors in the agricultural, transportation and mining sectors on the basis of their actual profits instead of presumed earnings. This measure, which was ultimately softened, was intended to reduce opportunities for tax evasion by businesses in these sectors (Boylan 1996: 12).

spending would help legitimize neoliberalism, which was popularly viewed as having benefited only the rich (Bartell 1992: 13, Boylan 1996, Weyland 1997). As Boylan (1996: 17) recounts:

...given the high visibility of the 'social debt' problem, a farsighted business class seeking economic security could recognize that if demands for increased social spending were not met, this failure would threaten the long-term political and economic stability of the entire system. ...As the president of the [CPC], Manuel Feliú commented, "It was a low price to pay for economic and social stability." (Boylan 1996: 17, 22).

Second, the threat of a fiscal deficit helped persuade business to accept the tax increase. Tax cuts enacted by Pinochet in 1989 and 1990 had reduced state revenue and helped to overheat the economy. Moreover, the Aylwin administration discovered a non-trivial budget shortfall upon assuming office due to an error in the outgoing regime's calculations (Marcel 1997). For the business sector, the possibility of a fiscal deficit "played on their greatest fear: resurgence of the populist economic policies pursued under the Allende Socialist government" (Boylan 1996: 16). In this context, "La Reforma Tributaria se transformó en un símbolo de la responsabilidad económica de la Concertación, despejando el fantasma del caos democrático," (Marcel 1997: 68).

The RN's willingness to negotiate accords with the Concertación in the early 1990s, which reflected divisions within the Alianza, was also critical for making the tax reform possible. Like key business leaders, the modernizing tendency that held leadership positions in the RN felt that the tax increase and the social spending it would finance were necessary for legitimating the economic model. As RN Senator Sebastián Piñera recounted:

...para consolidar y legitimar plenamente el modelo de desarrollo económico basado en la economía social de Mercado abierta se requerían... primero demostrar que este modelo podía servir para todos, ya que a éste se le percibía como eficiente pero injusto, es decir introducir mayores niveles de solidaridad para que éste se legitimara. (Piñera, interviewed by Marcel 1997: 61).

Moreover, these RN leaders strategized that accepting a moderate tax increase would enhance their electoral prospects by allowing the party to share credit for popular spending programs and building the RN's reputation as a non-obstructionist, centrist party (Boylan 1996, Boylan 1997: 211, Pollack 1999). RN president Andrés Allamand wanted to moderate the party's platform in order to attract votes from the PDC, from which he hoped to eventually wrest control of the political center (Pollack 1999: 104-5, 111, 115). The modernizing tendency warned that the party would suffer political fallout if it prevented the popular new government from delivering on its campaign promises (Boylan 1997: 211). Although much of the RN strongly resisted the tax increase (Marcel 1997: 79), the modernizing tendency was able to deliver the party's votes for reform in the Senate. The UDI, in contrast, remained staunchly opposed to the tax increase and pursued a political strategy of intransigent opposition to the government.

Although the CPC and the RN agreed to accept an increased tax burden in the context of the transition to democracy, they secured important concessions during negotiations with the Concertación that eroded the progressivity and revenue-raising capacity of the already modest proposal. The corporate tax rate was set at 15% rather than 20%, and a regressive two-point VAT increase was added to the package to make up for some of the associated revenue-shortfall (Boylan 14). In addition, the tax increases were made temporary—most importantly, the corporate tax rate would revert to 10% in 1994. Finally, the government informally agreed not to pursue any additional tax increases during the remainder of its term (Marcel 1997: 55).<sup>47</sup> These major concessions reduced the anticipated revenue-potential of the reform from 3% to 2% of GDP and necessitated renegotiation of the reform in 1993 (Boylan 1996: 14).

While the 1990 reform can rightly be viewed as a policy success for the Concertación in a context of strong business power during a period of uncertainty and instability, comparing tax revenue after the reform to tax revenue prior to 1988 illustrates how modest the advance actually was. Although corporate tax revenue increased by 1.5% GDP (Marfán 1998: 560), total tax revenue remained lower than it had

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<sup>47</sup>A few minor taxes were excluded from this agreement (Marfán 1998: 558).



been under the dictatorship before Pinochet's politically motivated tax-cuts in the late 1980s. In addition to switching the corporate tax base to distributed profits only, Pinochet had reduced the VAT rate from 20% to 16% just months before the 1988 plebiscite in an unsuccessful bid to bolster his popular support (Marfán 1998: 550). Total tax revenue accordingly fell from about 18.1% GDP in 1987 to 14.4% GDP in 1990. But after the 1990 reform, revenue only recovered to 16.9% GDP in 1992, more than one percentage point of GDP below the prior baseline (Marcel 1997: 41). As such, the 1990 reform served to recover most of the revenue lost thanks to the outgoing regime's irresponsible fiscal policy decisions, but not to move toward a new, higher-tax status quo.

Moreover, the factors that compelled business to accept increased taxation were unique to the transition period. Business had little incentive to compromise on taxation by the mid-1990s, when it became clear that the economic model was thoroughly consolidated. Accordingly, business associations adamantly resisted additional tax increases proposed by the government. Business did accept making the 1990 corporate tax increase permanent in 1993 for the sake of preserving fiscal discipline (Marfán 1998: 563; Marcel 1997: 57; Marfán 2005, author's interview), but only in exchange for a reduction of the top personal income tax rates, a number of other tax benefits and investment incentives, and another Concertación promise not to increase direct taxes during the next 4 years (Marfán 1998: 565; J.A. Guzmán 2005, author's interview).<sup>48</sup> Thereafter, business associations persistently lobbied for returning to Pinochet's short-lived system of exempting reinvested profits from taxation (SOFOFA 2002; Finance Ministry B 2005; CPC 2007; Muga 2008, author's interview).<sup>49</sup>

As with business, the RN's interest in compromising on taxation was also limited to the transition period. Changes in the balance of power within the Alianza led to more monolithic opposition from the right after 1990. First, the modernizing tendency within the RN lost ground to the more hard-line elements in the mid 1990s. A more conservative RN politician replaced Allamand as president of the party in 1997 (Pollack 1999: 180). Meanwhile, the reputations of Piñera and Matthei, the other two leading figures within the modernizing tendency, were damaged as a result of an internal party scandal at the end of 1992 (Pollack 1999: 175).<sup>50</sup> Second, the hard-line UDI gained seats in congress at RN's expense. After the 1997 congressional elections, the UDI's delegation in the senate outnumbered the RN for the first time, by 9 seats to 7 seats. Allamand's loss to UDI candidate Carlos Bombal in his bid for a Senate seat sealed the fate of RN's modernizing tendency, and the UDI made further advances in the Senate at the RN's expense in 2001.

As a consequence of this realignment within the right, which began in 1993, the RN moved away from its policy of negotiating accords with the Concertación. The government in fact had to rely on business, which feared a fiscal deficit, to bring the RN back to the negotiating table in 1993 and convince the party to accept preservation of the corporate tax at 15% (Marfán 2005, author's interview; Marcel 1997: 57).<sup>51</sup> Whereas Piñera and Matthei had been charged with negotiating the tax reform in 1990, the RN delegated the task of renegotiating the reform to Francisco Prat, a more conservative senator whose positions were much closer to the UDI (Pollack 1999: 178; Marfán 2005, author's interview).<sup>52</sup>

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<sup>48</sup>Business and the right anticipated early on that the Concertación would win the 1993 presidential election (Pollack 1999: 178).

<sup>49</sup>This issue arose in the context of the 2001 reform as well, as Zaldívar (2007, author's interview) recounted: "los empresarios ... alegaron que eso iba contra la inversión, que eso era disminuir el incentivo a la rentabilidad de las empresas, se abrió de nuevo la discusión si acaso la tributación tenía que ser sobre utilidades devengadas o utilidades percibidas porque actualmente se paga sobre devengadas y no sobre percibidas, y antiguamente se pagaba nada más que sobre percibidas."

<sup>50</sup>Matthei subsequently left the RN and joined the UDI.

<sup>51</sup>Marcel (1997: 57) asserts: "Tras un sistemático ejercicio de persuasión, que pasó por compartir con los empresarios proyecciones fiscales que ilustraban el efecto desestabilizador de la reversión de la Reforma Tributaria, se logró un acuerdo básico que permitió poner en marcha las negociaciones políticas con la oposición." RN Senator Otero explained during the debate on the reform: "ahora se nos presenta la siguiente situación: o aprobar la reforma tributario o provocar un déficit que debería enfrentar e próximo Gobierno. ... esa es una de las consideraciones que llevo a mi Partido a llegar a este acuerdo." (Diario de Sesiones del Senado, República de Chile, Sesión 1, Sept 1, 1993: 3472).

<sup>52</sup>In fact, Prat was engaged in a dispute at the time with Allamand and the modernizers in the context of the presidential election campaign (Pollack 1999: 178).

Given business and the right's firm opposition to further tax increases, tax reforms during the Frei administration were marginal. Income tax reform remained off of the agenda, but for some attempts to close loopholes that allowed investors to withdraw profits from firms without paying personal income tax. Although the RN agreed that some of these loopholes were technically unjustified and facilitated their elimination, business and the right defended the most important loopholes and blocked significant progress on this front. Although the Frei administration was not interested in increasing the corporate tax rate, which it viewed as adequate (Aninat 2007, author's interview), the right would have blocked any attempt to do so in the Senate.

### **V. Continuity and Change: Corporate Tax Non-Reform Under Bachelet (2006-2009)**

Bachelet's election as president marked a new period characterized by both change and continuity in tax politics. At the outset of Bachelet's term in 2006, business's instrumental power appeared weaker than before. On the one hand, business-right relations had come to be characterized by greater independence, and on the other hand, the Concertación won a slim majority in the Senate, creating the possibility that legislation could be passed without votes from the opposition for the first time. These changes augured well for equity-enhancing tax reform. As Lagos (2006, author's interview) optimistically remarked: "creo que la presidente Bachelet tiene mas grados de libertad que lo que tenia yo para [avanzar] en este terreno."

Nevertheless, corporate tax reform remained off of the agenda throughout Bachelet's administration. Several factors that had not been relevant during the Lagos' tenure in office contributed to this outcome. First, the new Finance Minister held more orthodox views on taxation than his predecessor, and relatedly, business's structural power increased with respect to corporate taxation. Second, a new economic context of record fiscal surpluses from high copper prices along with slower than expected growth lowered the priority of increasing taxation and created new political obstacles to reform. As before, however, business's instrumental power created major disincentives for equity-enhancing tax increases. Despite shifts in the nature of business-right relations, partisan linkages, along with business's other sources of instrumental power, remained strong. Accordingly, even a Finance Minister more attuned to the long-term imperative of increasing taxation and less concerned with the impact of direct tax increases on investment levels probably would have ruled out corporate tax reform as infeasible.

### **New Factors Discouraging Corporate Tax Reform**

Although many perceived Bachelet as belonging to the more progressive wing of the Concertación that favored more assertive efforts to improve equity,<sup>53</sup> she appointed a Finance Minister with more orthodox economic views on taxation who perceived little need for either increased revenue or equity-enhancing tax reform. In contrast to Lagos and his technical team, Andrés Velasco, who would later be appointed Finance Minister, maintained in a 2005 interview with the author that tax revenue in Chile as a percent of GDP was both adequate for the state's needs and appropriate for the country's level of development. While Eyzaguirre believed that the corporate tax was too low, Velasco (2005, author's interview) asserted that the corporate tax rate was "more or less where it should be." Further, Velasco dismissed progressive taxation as ineffective for raising revenue. Like economists who had promoted first-generation tax reforms, Velasco (2005, author's interview) advocated redistribution on the spending side of the fiscal equation only, without concern for the distributive impact of taxation.

Given the new Finance Ministers' more orthodox views on taxation, it is not surprising that business's structural power increased with regard to corporate taxation during the Bachelet

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<sup>53</sup>A business association informant asserted that this view was prevalent among the business community (ABIF 2005, author's interview). While Bachelet's program of government did not deviate significantly from other Concertación governments, several of her proposals can be considered more left-leaning in the Chilean context. Bachelet for example proposed preventing for-profit educational establishments from receiving state subsidies in April 2007, a proposal soundly rejected by business and questioned by many Concertación economists as well. See for example *El Mercurio*, April 14, 2007: "La operación de La Moneda para salvar la iniciativa estrella del ministro Velasco."

administration. Whereas Eyzaguirre maintained that the low corporate tax promoted personal income tax evasion rather than investment, Velasco (2005, author's interview) adhered to the alternative view held among Chilean economists that the prevailing income tax rate structure stimulated investment: "having a big gap between the corporate income tax and the personal income tax is a big incentive for firms to save." More generally, like many orthodox economists, Velasco (2005, author's interview) perceived a significant tradeoff between growth and equity, and he solidly prioritized growth: "This is a country which is still relatively poor.... so we have to grow... it seems to me any governmental policy can't do everything at once, and [growth] ought to be the one thing we worry about a lot." The following quotation summarizes Velasco's views on taxation:

A redistributive strategy which is based on fairly non-progressive taxes but a highly focussed pattern of spending... makes sense to me. ...you won't raise a lot [of revenue] otherwise, and ...the strategy also has less of a growth cost because the tax system is mostly VAT, [which is] less distortive. So trying to ballance out growth and redistribution, this way of proceeding strikes me as a reasonable one. (Velasco, author's interview 2005)

Structural power, through Velasco's perception that corporate tax increases would in fact deter investment, along with his lack of interest in raising additional tax revenue, helped ensure that most second-generation reforms would remain off of the government's agenda. By his own account, Velasco helped dissuade Bachelet, who did not have any training in economics, from including tax increases (other than measures to fight evasion) in her program of government during the 2005 campaign.

It is worth noting that Velasco's appointment to the Finance Ministry was not a consequence of business power, despite the fact that his tax views were more compatible with business preferences than Eyzaguirre's had been. Bachelet seriously considered Budget Director Mario Marcel, the second in command to Eyzaguirre, for the position.<sup>54</sup> Marcel, like his colleague Eyzaguirre, felt that income tax reform was imperative.<sup>55</sup> Considerations unrelated to economic policy probably tipped the scales in favor of Velasco. Bachelet's desire to maintain distance from the Concertación party establishment and her commitment to include new faces in her administration (Navia 2006)<sup>56</sup> placed Velasco at an advantage; in contrast to Marcel, a long-time PS militant, Velasco did not belong to any political party. In addition, Velasco developed a close personal relationship with Bachelet as the head of the committee that designed her program of government during the presidential campaign, whereas Marcel's responsibilities as the incumbent administration's Budget Director curtailed his role in the campaign, although he regularly provided policy advice.<sup>57</sup> In the end, Bachelet's decision may have been highly contingent. According to one account, Bachelet had in fact planned to appoint Marcel but changed her mind at the last minute.

A new economic context of abundance when Bachelet assumed the presidency in 2006 also helped to remove equity-enhancing tax reforms from the administration's agenda. Sky-rocketing international prices for copper, a major Chilean export, created record fiscal surpluses (Figures 2.6, 2.7). While windfall revenue from the state-owned copper company CODELCO was invested in a stabilization fund and hence could not be used to finance current expenditures, tax revenue also swelled thanks to increased profits in the privately-owned mining sector (Figure 2.8). Velasco repeatedly maintained that prevailing levels of tax revenue were sufficient to fund Bachelet's social spending initiatives, including a major pension reform.<sup>58</sup> In addition, taking the advice of prominent Concertación economists, Velasco reduced

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<sup>54</sup>Marcel was widely recognized as a key contender for the position. *Revista Cosas*, March 16, 2007: "Mario Marcel: El "niño mateo" de las platas públicas."

<sup>55</sup>Marcel (2007, author's interview) recommended reforms to close personal income tax loopholes rather than increasing the corporate tax rate. The Lagos administration considered but ruled out such reforms as infeasible in 2000.

<sup>56</sup>See also *Qué Pasa*: "Cómo Andrés Velasco conquistó a Bachelet," by Claudia Farfán and Francisca Skoknic, [www.icarito.cl/medio/articulo/0,0,38039290\\_101111578\\_186584292,00.html](http://www.icarito.cl/medio/articulo/0,0,38039290_101111578_186584292,00.html) Accessed Oct. 5, 2009.

<sup>57</sup>Ibid., *Revista Cosas*, March 16, 2007: "Mario Marcel: El "niño mateo" de las platas públicas."

<sup>58</sup>In response to pressure from Concertación deputies to undertake a revision of the tax system with an eye toward greater equity, Velasco responded: "Tenemos un programa a cuatro años que está financiado. ...Una reforma tributaria no está en la agenda de este Gobierno." *El Mercurio*, Jan 11, 2007: "Rebelión concertacionista contra Velasco."

the surplus target established by the structural surplus rule (*regla de superávit estructural*), implemented in 2000 as an anti-cyclic measure, from 1% to 0.5% of GDP in May 2007. This adjustment freed additional funds amounting to USD 650 million for investment in education.<sup>59</sup>

The context of fiscal surplus also created new political obstacles to tax increases by weakening the government’s ability to appeal to fiscal discipline. Opponents could make the simple and compelling, though technically questionable argument that the government should spend the resources it already had. As the President of the Socialist Party (2006-present) explained:

El Estado tiene ahorros como nunca en la historia de Chile, de manera que la existencia de esa masa de dinero se ha tornado muy difícil la discusión. Yo sé que el gasto social tiene que financiarse con ingresos permanentes, que los ingresos del cobre son transitorios, pero aún cuando conceptualmente uno pueda decir los gastos son permanentes y estos ingresos son transitorios, por lo tanto debemos resolver el problema permanente con medidas permanentes, esta segunda parte hoy en la discusión política chilena es muy difícil. Es prácticamente imposible porque sale de inmediato el argumento fácil que dice: pero si el Estado está lleno de plata, ¿para qué quiere más plata? (Escalona 2007, author’s interview)

This argument found adherents among the Concertación as well as the right (author’s interviews: Zaldívar 2007, Escalona 2007). Even Concertación legislators who continued to advocate increasing tax revenue agreed that the economic context made it extremely difficult to advance on that front (Montes 2007, author’s interview).<sup>60</sup>

Meanwhile, slow growth motivated the executive to *reduce* taxes. While growth had reached 6% at the end of Lagos’ term, it slowed to under 5% in the first years of Bachelet’s term and dipped down to 3.2% in 2008 (Figure 2.9). Although growth rates were higher than during the four years following the East Asian Crisis, the government and the private sector found them unsatisfactory. Given Velasco’s prioritization of growth and his perception of investor sensitivity to taxation, it came as no surprise that the Finance Ministry focused its efforts on designing multiple reform packages intended to stimulate investment from 2006-2008, which included a battery of tax incentives.<sup>61</sup>

**Figure 2.6: Fiscal Surplus (superávit efectivo), % GDP**

Sources: DIPRES 2006, 2007: *Estadísticas de las Finanzas Públicas*, Ministerio de Hacienda 2006, 2007, 2008: *Estado de la Hacienda Pública*

	First Semester	End of Year
2005	2.8	4.7
2006	4.2	7.9
2007	5.3	8.7
2008	4.0	

<sup>59</sup>*El Mercurio*, May 22, 2007: “Bachelet cede a presiones para aumentar el gasto y anuncia millonaria inversión social.”

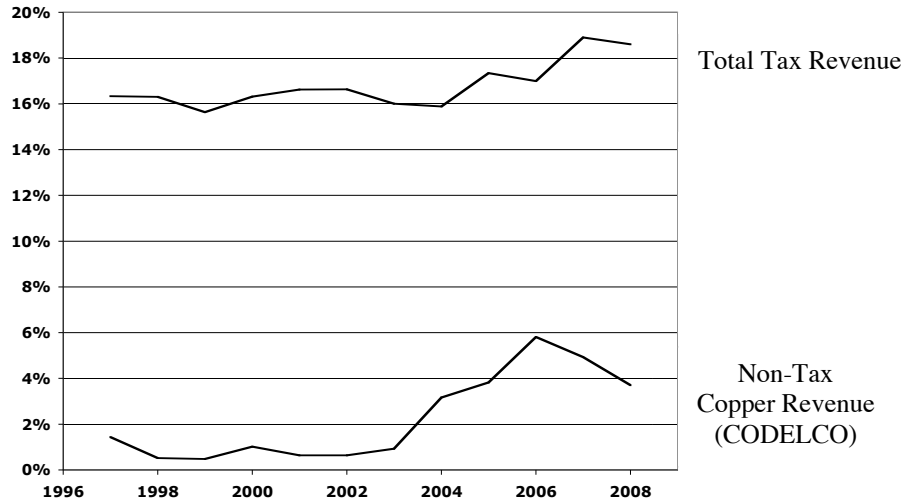
<sup>60</sup>This discussion is consistent with Karl’s (1997) findings for capital deficient oil-exporters. During the oil boom, “As oil money flowed into state coffers on an ever-increasing basis, it became politically more and more difficult to raise domestic taxes,” (Karl 1997: 198-99).

<sup>61</sup>Plan *Chile Compite*, legislated in September 2006, included a stamp tax reduction, a 35% tax credit for investment in research and development, and other corporate tax benefits. Plan *Chile Invierte*, proposed in 2007, included instantaneous depreciation for investment, which was ultimately rejected in Congress. Other tax benefits legislated in 2007 included a reduction of the tax on imports of software (January 2007), a temporary increase of the tax credit for investment in fixed assets (February 2007), and capital gains tax cuts (June 2007). Additional tax cuts were legislated in 2008, including another stamp tax reduction and a gas tax reduction (Chapter 4, Part 5). Business’s instrumental power may or may not have contributed to Velasco’s initiation of these tax incentive bills. While Velasco enacted many measures that business had lobbied for, interviews with Finance Ministry and business informants suggest that he likely viewed these measures as technically correct and desirable based on his own extensive academic training, regardless of business mobilization (author’s interviews: Aninat 2007, Beyer 2007, Muga 2008).

**Figure 2.7: Copper Prices, USD/pound, 2004-2009.**  
 Source: www.kitco.com (accessed Sept. 26, 2009)



**Figure 2.8: Total Tax Revenue and Non-Tax Copper Revenue (%GDP), 1997-2008**  
 Sources: DIPRES: *Estadísticas de las Finanzas Públicas*, SII: *Serie Ingresos Públicos*



**Figure 2.9: Growth Rates (%), 2004-2008**  
 Source: www.bcentral.cl *Producto Interno Bruto Serie Anual*

Year	Growth Rate
2004	6.0
2005	5.6
2006	4.6
2007	4.7
2008	3.2

### **Instrumental Power: the Continued Strength of Partisan Linkages**

In 2005, while growth was still strong and before the fiscal surplus exploded, future Finance Minister Velasco (2005, author's interview) mused: "if I think as a politician a minute, ...I don't think I will be spending my political capital screwing around with taxes. ...In order to get a good chunk of [revenue] from direct taxes, you'd have to raise political hell." With regard to increasing the corporate tax, he asserted: "The business community will really agitate against it," even if a rate increase of only a few points were at stake. Velasco's remarks suggest that business's instrumental power contributed to his disinterest in corporate tax reform and would have helped to keep such initiatives off the agenda even had the administration faced more pressing revenue needs.

Along with cohesion and government-business concertation, partisan linkages remained a strong source of instrumental power from 2006-2009. The right continued to be a formidable opposition force in the Senate. And despite efforts on the part of both business and the right to create the appearance of greater independence, the fundamental aspects of business-right relations remained unaltered. In practice, the right continued to defend business interests, with one noteworthy exception in 2007.

### ***The Right's Continued Strength in Congress***

The right retained strong representation in congress from 2006-2009, despite the fact that the Concertación won its first ever majority in the Senate in the 2005 elections. The Alianza held 18 seats after the election,<sup>62</sup> just two seats behind the Concertación. Moreover, the Concertación's majority proved ephemeral. Weakened internal discipline rendered the majority dysfunctional by early 2007, and the balance of power reverted to parity between the two coalitions later that year when PDC senator Adolfo Zaldívar and PPD senator Fernando Flores left the Concertación and assumed the status of independents. Thereafter, as was the case during the Lagos administration, a few swing voters determined the fate of reforms in the Senate. As a Finance Ministry informant observed: "en general, toda votación depende de lo que estos dos senadores hagan" (Finance Ministry 2008a, author's interview).

The Concertación's failure to retain its majority, which enhanced the right's influence, resulted in part from Bachelet's relatively weak authority with respect to the coalition party establishment. Bachelet's attempt to distance herself from the Concertación party leadership during her presidential campaign and her first years in office (Boas 2009, Navia forthcoming) translated into a much weaker ability to align the parties behind her administration's policy initiatives compared to Lagos. For example, although Bachelet's first cabinet created balance among the coalition parties, those appointed were not necessarily the candidates advocated by their parties, to the latter's annoyance (Sehnbruch 2007: 7-8, Navia forthcoming: 9). Finance Minister Andres Velasco, moreover, did not hold membership in any Concertación party, in contrast to his three predecessors. Whereas Lagos was able to use his authority and the respect he enjoyed within the Concertación to ensure support from the coalition even on initiatives that generated substantial internal discontent (for example, the 2003 VAT increase), Bachelet and her Finance Minister frequently had difficulty disciplining Concertación legislators. This problem was particularly evident with regard to the Finance Ministry's initiatives to promote growth (see below), but difficulties also arose in other areas including educational reform, electoral system reform, and pension reform (Boas 2009). Multiple cabinet reshufflings, which are unusual for Concertación governments, were a symptom of Bachelet's difficulty in maintaining order within the Concertación.

Growing discontent within the coalition regarding the economic model in combination with personal rivalries within the PDC also contributed to the disintegration of the Concertación's senate majority. Bachelet's appointment of a very orthodox Finance Minister helped to deepen dissatisfaction within the Concertación regarding the economic model. The left-wing of the coalition complained that economic policy continued to benefit the rich without satisfactorily addressing the problems of the majority. Adolfo Zaldívar in particular had built a reputation for criticizing the economic model and

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<sup>62</sup>Including one independent, Bianchi, who tended to vote with the right.

denouncing what he viewed as collusion between the political establishment and big business.<sup>63</sup> Zaldívar and the PDC more broadly demanded that the Concertación provide more benefits for the indebted and vulnerable “middle class” along with small and medium businesses.<sup>64</sup> Personal rivalries within the factionalized PDC, which had lost its prominent position within the Concertación after a weak performance in the 2005 parliamentary elections (its senatorial block fell from 13 to 6 seats) and its failure to secure the presidential candidacy, exacerbated disciplinary problems within the coalition. Zaldívar repeatedly broke ranks with the Concertación in the senate partly in a strategic bid to further his own personal political ambitions.<sup>65</sup>

### ***Business as the Right's Less Overt Core Constituency***

Business-right relations underwent noteworthy changes from the mid-2000s through Bachelet's term in office. On the one hand, business leaders refrained from overt participation in right party politics, in contrast to their heavy-handed involvement in the 1990s. On the other hand, the right sought to demonstrate greater independence from the business sector in order to improve its electoral fortunes. Appearances aside, however, I will argue that partisan linkages remained a fundamental source of instrumental power.

A new generation of more moderate businessmen who eschewed open association with the right assumed leadership of the major peak associations after 2002.<sup>66</sup> As the CPC's General Manager explained:

Tenemos una política bastante clara en los últimos años de no confundir cuando de repente tenemos una crítica al gobierno que no se interprete como una crítica política. Sino que una crítica... a políticas. No con un fin de perjudicar al gobierno para que la oposición gane la elección. (Muga 2008, author's interview).

From the government's perspective, the change was dramatic. Lagos (2006, author's interview) observed: "...defienden sus intereses empresariales como en cualquier parte... Pero la defensa de sus intereses empresariales tiene que ver con la defensa de sus empresas, no con una concepción ideológica-política." Marcel (2005, author's interview) expressed similar perceptions: "los gremios empresariales en los últimos años ...han ido tomando más distancia de la política. Anteriormente las organizaciones empresariales eran muy militantemente de derecha. Ahora probablemente lo son igual, pero en el fondo se involucran menos en la discusión política."

This change in part reflected the fact that the new business leaders were not as closely associated with the military regime as their predecessors (E. Guzmán 2005, author's interview). Pinochet's detention in London and the subsequent discovery of his embezzlement of state funds and tax evasion blemished the reputation of the older generation of business leaders who had remained fiercely loyal to the general (E. Guzmán 2005, author's interview), and may thus have facilitated the change of guard.

Under the new leadership, overt coordination with the right parties and aggressive opposition to reforms that threatened private sector interests gave way to a new style of more cordial relations with the government. While businessmen for the most part approved of CPC president Ariztía's highly confrontational stance toward the Lagos administration during his first two years in office (Urenda 2005, author's interview), his successor, Juan Claro,<sup>67</sup> demonstrated through the *Agenda Pro-Crecimiento* initiative that a less heavy-handed and more respectful stance toward the government could serve business interests. The move toward less confrontational business-government relations was facilitated by the fact

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<sup>63</sup>*Diario Estrategia*, April 16, 2007: "Senador Adolfo Zaldívar: Este Gobierno Ha Profundizado el Desastre que Dejó la Política de Lagos."

<sup>64</sup>Adolfo Zaldívar, "Urge dar un respiro a la paciente clase media," Jan. 12, 2005. Senado, Departamento de Prensa, Santiago. [www.senador.cl/prontus\\_senado](http://www.senador.cl/prontus_senado) Accessed April 9, 2009.

<sup>65</sup>*El Mercurio*, Santiago, July 1, 2007: "Adolfo Zaldívar: decidido a provocar un quiebre en la Concertación," by Sergio Espinosa. Zaldívar's strategies created short-term payoffs for the politician. In 2008, after his expulsion from the PDC, he became president of the Senate thanks to negotiations with the Alianza.

<sup>66</sup>These leaders included Juan Claro, Felipe Lamarca, Felipe Bruno and Hernán Somerville.

<sup>67</sup>Claro was elected president of the CPC in 2002, while still president of SOFOFA.

that the reforms included in Lagos' campaign platform that business most adamantly opposed, including the Anti-Evasion Reform as well as labor reforms, had already been legislated. As Ariztía (2005, author's interview) recalled:

A mí me tocó el periodo más duro de cambios, y coincidió que junto con mi salida se terminaron los cambios que significaban tener una relación más dura con las autoridades de gobierno. Si tu analizas desde Juan Claro hasta hoy, lo único que se discutió con efecto costo para las empresas fue el tema Royalty. Pero fue un proceso largo donde no fue necesario una discusión violenta, como nos tocó a nosotros en el proceso laboral o tributario.

The move away from confrontational relations was also facilitated by Claro's excellent personal rapport with top leaders in the Lagos administration (author's interviews: Eyzaguirre 2007, Urenda 2005, CChC 2006).<sup>68</sup>

Simultaneously, the right intensified efforts to free its public image from close association with the business sector. This strategic move, which had begun with Lavín's 1999 presidential campaign, was intended to improve the right's electoral prospects, as a CEP researcher with first-hand knowledge of business-right relations explained:

La Alianza, una de las debilidades que tiene es que la población lo identifica demasiado con el empresariado. Y hace buen tiempo, la Alianza está tratando de desmarcarse de esa visión, de mostrar gestos de independencia. ... la Alianza siente que los empresarios no son un aporte, mas bien son un lastre para su desempeño. (Beyer 2007, author's interview)<sup>69</sup>

Displaying greater distance from big business was part of Lavín's strategy of appealing to ordinary voters (Boas 2009), an electoral imperative for any political party. Lavín was careful to avoid interference from the "*poderes fácticos*" in his campaign; his efforts to eschew association with the military regime antagonized the leaders of the peak associations, who remained fiercely loyal to Pinochet (E. Guzmán 2005, author's interview). Lavín's attempt in 2005 to embrace as his own the issue of income inequality, the traditional banner of the left, can be viewed as a continuation of this distancing strategy.<sup>70</sup>

Business-right differentiation continued after Bachelet's election. While business pursued non-confrontational relations with the new administration, the right assumed a position of active opposition after its fourth consecutive loss of the presidency to the Concertación (Escalona 2007, author's interview). Accordingly, informants maintained that business-right relations had changed substantially from the 1990s. As Beyer (2007, author's interview) observed: "Hoy día hay mucho más distancia del mundo política de la derecha del mundo empresarial." Similarly, E. Guzmán (2005, author's interview) asserted:

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<sup>68</sup>Despite the realignment of power within the business sector, cohesion on tax issues remained strong. The new business association leaders remained opposed to corporate tax increases and tax increases more generally. For example, a business informant aligned with the more moderate leadership maintained: "creemos que Chile tiene una carga tributaria que es más que suficiente. Se pueden hacer todas las políticas sociales que corresponden en términos de salud, en términos de vivienda, en términos de educación. ... Creemos que el Estado no está bien gestionado ... no hay ninguna esfuerzo de parte del gobierno en mejorar la gestión," (F. Gazmuri 2005, author's interview). Likewise, when asked how the new generation of business leaders would react to a proposed corporate tax increase, Lagos (2006, author's interview) remarked: "Como dice Galbraith, cuando el pobre escucha la palabra impuesto, sonríe. Piensa que a lo mejor algo de ese impuesto le va a caer. Cuando el rico escucha la palabra impuesto, se pone muy triste. Piense que algo de ese impuesto se lo van a quitar. Hay una reacción instintiva." Likewise, although E. Guzmán (2005, author's interview) asserted that "hoy en día el empresariado o el mundo fáctico está más dividido," he acknowledged that taxes remained a unifying issue: "todos en materia tributaria ... son contrarios al exceso de aumentar la carga impositiva." Business solidarity on taxation remained strong, even when reforms threatened only a single sector. As discussed in Chapter 4, Part 5, the Bachelet administration's 2008 proposal to restrict the use of a VAT benefit for the construction sector elicited opposition from business more broadly, although the strategic design of the larger reform package had the effect of limiting the CPC's involvement.

<sup>69</sup>Other informants advanced similar analyses: "Within the UDI ... there is an increasing tension between the people linked to the business community [and the] politicians [who] want to win elections" (A. Velasco 2005, author's interview).

<sup>70</sup>Several informants maintained that public financing for political parties legislated in 2003 helped give the right parties greater latitude to act independently of the business sector (author's interviews: Beyer 2007, E. Guzmán 2005). See Garretón 2005: 180-86 on this public financing law and money in politics more generally.



“Por una parte, un empresariado que ya no está monolítico y por otro lado, partidos políticos que tratan de independizarse, hace que los fácticos... no tengan tanta influencia.”

However, while these changes in business-right relations are noteworthy, I argue that in practice they have not significantly altered the core constituency relationship. Despite E. Guzmán’s (2005, author’s interview) assertion that business leaders no longer wielded as much influence in Alianza politics, he was quick to point out that the comparison is relative:

No tengan tanta influencia. La tienen, ojo. No engañamos. Y tienen mucho, porque tienen el dinero. Pero no la tienen como era en todo la década de los noventa.  
--*El vínculo con los partidos es más débil? Es más débil que en la década de los noventa. No digo que es débil. Es tight, es tight.*

Business continued to support the right parties, if less overtly, despite comfortable coexistence with Concertación governments (E. Guzmán 2005, author’s interview). Informal ties between business and the right persisted, and business leaders continued to participate in right party politics. For example, after his term as president of SOFOFA ended in 2005, Juan Claro, still a member of the industrial association’s board of advisors, convoked a small group of prominent business leaders, all of whom had ties to the RN and/or the UDI. This group called itself the “‘neofácticos’ en relación a los ‘fácticos’ de la SOFOFA que movieron sus piezas durante el régimen militar.”<sup>71</sup> Claro and his associates maintained regular contact with the RN and the UDI during the campaign. Claro was rumored to have brokered an agreement between the RN and UDI to grant Andrés Allamand a secure district for his senatorial campaign and to have conversed directly with Lavín and Piñera regarding the advantages of running a single Alianza candidate in the first round of the election. Claro and Lamarca were reportedly offered candidacies for Congress by the RN and the UDI.<sup>72</sup> Although they turned down the offers, both business leaders purportedly harbored presidential aspirations (E. Guzmán 2005, author’s interview).

Most importantly, the Alianza continued to defend business interests on economic policy in congress from 2003-2009, with occasional breaches (Luna 2010).<sup>73</sup> Partisan linkages, particularly to the UDI, remained intact, despite the trend toward less overt mutual association. Business associations and the right were less likely to actively or openly coordinate opposition to reform proposals. But simultaneous business-right opposition even without business-right coordination would make increasing taxes a difficult challenge.

### ***An Exception that Highlights the Rule: Business-Right Fissures on Accelerated Depreciation***

A remarkable exception to the right’s strong record of defending business interests occurred in 2007, when strategic political calculations led the Alianza to vote against a tax benefit supported by big business. The Finance Ministry proposed allowing businesses to apply instantaneous depreciation to 50% of the cost of new fixed assets from 2007 to 2009 as a measure to promote investment and spur sluggish growth. Business and orthodox economists strongly favored the measure (Ovalle 2007), and the Alianza voted for the reform in the House of Deputies as expected.<sup>74</sup> However, the reform stimulated significant discontent within the Concertación. The left wing of the coalition denounced the reform as an unnecessary tax break for big business that failed to address the needs of small and medium enterprises. Concertación legislators maintained that those businesses that stood to benefit from accelerated depreciation had already planned investment projects and would initiate them with or without the reform. Discontent within the coalition became a serious political problem after the bill passed to the Senate,

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<sup>71</sup>*El Mercurio*, Oct. 30, 2005: “El castigo empresarial a Felipe Lamarca.”

<sup>72</sup>*Ibid.*

<sup>73</sup>See discussions of the government’s 2006 VAT reform and a 2008 proposal to restrict a VAT exemption that benefited the construction sector in Chapter 4, Parts 1 and 5.

<sup>74</sup>The reform was unanimously approved in the Finance Committee (Comisión de Hacienda, Cámara de Diputados, República de Chile, Boletín 4.922-05, March 21, 2007). On the floor, 24 Alianza deputies voted in favor and 3 abstained. UDI Deputy Dittborn, a longtime member of the Comisión de Hacienda, asserted that the tax benefit was the most important component of the government’s pro-investment package and argued that the benefit should have been granted for a longer period of time (Cámara de Diputados, República de Chile, Legislature 355<sup>a</sup>, Sesión 7<sup>a</sup>, March 22, 2007).

where a handful of Concertación legislators made clear that they would not vote for the reform, despite intense negotiating efforts on the part of the executive and the Concertación party leaders.

This situation created a multi-faceted political opportunity for the right. By switching from supporting to opposing the reform, the Alianza could simultaneously exacerbate divisions within the Concertación, demonstrate independence from big business and the business associations, and claim to represent the interests of small and medium enterprises, a constituency the right had long sought to cultivate. Accordingly, the Alianza announced that it would vote against the reform unless the government included a variety of tax cuts for small and medium businesses, appropriating the argument that the tax benefit in question helped only big business.<sup>75</sup> The Finance Ministry responded by appealing directly to the CPC and its member associations to convince the right to vote for the reform.<sup>76</sup> However, this move simply increased the Alianza's perceived returns to opposing the reform by making the differences between the right and big business even more manifest: "cuando [el gobierno] ...le pidió la ayuda de los empresarios, para que los empresarios intercedieron con la Alianza, la Alianza dijo que no, somos independiente del mundo empresarial. Fue una oportunidad preciosa, que pocas veces se da en política," (Beyer 2007, author's interview). The reform was defeated on the Senate floor with opposition votes from the Alianza and three dissident Concertación senators.

The Alianza's opportunistic decision to oppose a reform that was consistent with its policy preferences succeeded in weakening the Concertación politically, although it did not necessarily suffice to establish the right as independent of business in the eyes of the public (Beyer 2007, author's interview). The vote in the Senate was interpreted as a major political defeat for the Finance Minister.<sup>77</sup> Moreover, the Alianza's strategy helped deepen tensions within the Concertación and raised the political profile of the dissident Concertación senators (Beyer 2007, author's interview). Zaldívar was expelled from the PDC later that year<sup>78</sup> and joined a small block of independents in the Senate, effectively putting an end to the Concertación's majority.

The Alianza's rejection of the accelerated depreciation tax benefit was dramatic in the extent to which it showcased conflicts between business and the right in a policy realm generally characterized by consensus between these actors. However, I argue that this episode does not indicate that business is losing its status as the right's core constituency. Instead, this episode constitutes a deviation motivated by the occasional need to subordinate business's policy interests to strategic considerations. As Gibson (1992: 28) argues, periodic conflicts can be expected to arise between a right party and its core constituency as a result of the party's attempts to attract a broader electorate. The UDI and the RN are clearly shifting tactics in order to better compete with the Concertación in post-transition Chile. However, the Alianza's broader policy record, if not its rhetoric, provides evidence that business remains a core constituency.<sup>79</sup> In fact, the Alianza's presidential candidate, Piñera, and his economic advisors advocated accelerated depreciation early on in the 2009 campaign, notwithstanding the coalition's rejection of the measure in 2007.<sup>80</sup> Nevertheless, it remains to be seen if business's instrumental power will decline in the future as a result of continued electoral pressures on the right.

### **The Continued Need and Limited Prospects for Income Tax Reform**

Despite the copper boom and associated fiscal surpluses, a solid case could still be made during Bachelet's term for income tax reform. The copper boom would most likely be temporary—in fact,

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<sup>75</sup>*El Mercurio*, April 15, 2007: "Alianza crea comité para 'Chile Invierte,'" *Diario de Sesiones del Senado*, República de Chile, Legislatura 355a, Sesión 9a, April 10, 2007, and Sesión 11a, April 17, 2007.

<sup>76</sup>*El Mercurio*, April 14, 2007: "La operación de La Moneda para salvar la iniciativa estrella del ministro Velasco."

<sup>77</sup>*El Mercurio*, April 18, 2007: "Alianza y Concertación rechazan ley pro inversión."

<sup>78</sup>The main issue that precipitated Zaldívar's expulsion was his decision to side with the Alianza against an influx of funds for the embattled Transantiago transportation system.

<sup>79</sup>E. Guzmán (2005, author's interview) in fact made note of the gap between the right's campaign rhetoric and its voting record when he asserted that the right party legislators for the most part felt free to ignore the positions Lavín assumed in the press when voting in Congress.

<sup>80</sup>*El Mercurio*, July 22, 2009: "Velasco entra en la campaña: cuestiona el programa económico de Piñera y destaca equipo de Frei," *El Mercurio* July 10, 2009: "Piñera presenta propuestas económicas y propone abrir el 20% de Enap y Codelco a Bolsa."

copper prices at the beginning of 2009 had fallen back to their 2004 values—whereas expanding social spending entailed permanent expenditures. Consequently, although enough revenue was available for Bachelet’s flagship pension reform, experts questioned whether or not the state would have the revenue to support other initiatives included in the President’s program of government, including expansion of childcare, expansion of Lagos’ health care reform (*Plan AUGE*) to cover more illnesses, and provision of greater financial support for municipalities. Former Budget Director Marico Marcel voiced these concerns in 2007: “La actual carga tributaria es adecuada para las políticas que hoy existen, pero para todo lo que está por hacerse, para todas las cosas que es necesario plantearse a futuro, no están esos ingresos tributarios.”<sup>81</sup> Marcel also called attention to the large fiscal cost of Velasco’s investment tax incentives, which the administration did not fully disclose (Marcel 2007, author’s interview).<sup>82</sup> Likewise, former president Aylwin joined former president Lagos in calling for a social pact to raise more revenue for social spending: “Si para lograrlo fuera necesario dotar al Estado de mayores recursos por la vía tributaria, debería intentarse y podrían lograrse los consensos necesarios.”<sup>83</sup>

However, business’s strong instrumental power and the context of fiscal surplus probably would have deterred even a Finance Minister who favored increasing taxation from attempting reform. Marcel, Velasco’s contender for the position of Finance Minister who advocated significant income tax reform, explicitly acknowledged the political difficulties created by these factors in a 2007 interview with the author. Accordingly, any measures designed to increase income taxes were probably over-determined for failure; anticipations of business-right opposition as well as the greater difficulty of justifying tax increases as necessary to maintain fiscal discipline probably would have kept significant reform off any Finance Minister’s agenda. However, it should be noted that tax policy would have been managed differently had Marcel been appointed Finance Minister; he would not have proposed the uncompensated tax cuts legislated by Velasco.<sup>84</sup>

## V. Conclusion

This chapter has argued that business’s strong instrumental power, based on partisan linkages, cross-sectoral cohesion, and government concertation with business on economic policy, kept significant corporate tax increases, and income tax reform more generally, off the agenda from 1991-2009, despite the fact that reform in this area is critical for improving tax capacity and tax equity in Chile. Although President Lagos actively sought to raise more revenue to support expanded social spending, and although his Finance Minister maintained that the corporate tax rate was much too low, only marginal initiatives were undertaken to increase corporate taxation. During the Bachelet administration, factors other than instrumental power contributed to non-reform. Bachelet’s Finance Minister did not feel that the corporate tax needed to be increased, and the context of unprecedented fiscal surplus combined with slow growth after 2005 made increasing taxation an even more daunting political challenge. However, instrumental power also constrained prospects for reform during this period.

In contrast to earlier work, I find that business’s influence over the tax reform agenda far exceeded business influence after the executive had proposed reform initiatives. This finding is significant because it suggests that business in Chile is more powerful than previously understood. Aggressive business-right mobilization against the 2000 Anti-Evasion Reform sufficed to dissuade the Lagos administration from attempting more consequential tax reforms during the remaining four years of its term. In other words, the mere anticipation of business-right resistance kept important reforms that the executive might

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<sup>81</sup>Marcel quoted in *El Mercurio*, March 17, 2007.

<sup>82</sup>According to Marcel’s (author’s interview 2007) estimates, the cost of the tax incentives, together with capitalization of the Central Bank, reached 1000 million dollars, on the order of 0.6% GDP. See also Sandra Novoa Fernández, “La apuesta del Gobierno por el estímulo tributario,” *El Mercurio*, Santiago, March 18, 2007.

<sup>83</sup>Aylwin quoted in *El Mercurio*, Jan. 9, 2007.

<sup>84</sup>Furthermore, if not for Velasco’s influence, Bachelet might have worked more actively on other equity-enhancing tax reforms, especially given continual pressure to do so from Concertación legislators. *El Mercurio*, May 26, 2007: “Gobierno enfrentará presión por mayor gasto ante cambios a la reforma provisional,” *El Mercurio*, July 6, 2007: “Parlamentarios piden abrir debate tributario,” *El Mercurio*, Jan. 11, 2007: “Rebelión concertacionista contra Velasco.”

otherwise have sought to enact off the agenda, without need for business to actively expend resources to achieve influence.

This chapter also calls into question Weyland's argument that strong encompassing organization improves prospects for redistribution and his characterization of Chile as a success story for progressive taxation based on the case of the 1990 reform. I demonstrate that strong peak associations, which contributed to cohesion, in fact helped business prevent tax increases in subsequent years. As such, the 1990 reform constituted a unique business-right concession in the extraordinary political context of the transition to democracy. Moreover, although it did enhance tax equity and provided critical resources for the new democratic government, the 1990 reform in fact achieved little more than reversing tax cuts enacted by a military regime that had turned to "populist" measures in a bid to bolster its legitimacy before the plebiscite and to reward its core constituency.

### **Post-Script: President Piñera's Unexpected 2010 Reform Initiative**

In January 2010, Chile elected its first right-coalition president since the transition to democracy. The RN's Sebastián Piñera defeated Concertación candidate Eduardo Frei 52% to 48%. With the right's ascent to the presidency, corporate tax non-reform seemed ensured for the next four years. Piñera's campaign platform clearly stated that he would not increase taxes; rather, his government would consider legislating new tax benefits to promote growth and investment.<sup>85</sup> The candidate asserted that if raising revenue proved necessary, options included controlling tax evasion, stimulating growth, and using public funds more efficiently.<sup>86</sup>

However, in the aftermath of the 8.8 magnitude earthquake that devastated central Chile on February 27, 2010, the Piñera administration confounded expectations by including in his proposed package to finance the costs of reconstruction a corporate tax increase, along with several other tax increases essentially identical to initiatives proposed by the Concertación in previous years but defeated with votes from the right.<sup>87</sup> The corporate tax rate would increase to fully 20% for the year 2011, decreasing to 18.5% in 2012 and returning to 17% in 2013. The corporate tax increase would contribute approximately USD 1260 million toward the total of USD 8431 million the government sought to finance reconstruction; the full set of tax measures together would contribute USD 3231 million.<sup>88</sup> The corporate tax reform met with surprise from all quarters and accolades from the Concertación.<sup>89</sup>

The reforms proposed by Piñera are remarkable even in the context of the unanticipated shock created by the earthquake. That the state required an extraordinary influx of revenue in order to address urgent social needs in the affected regions and to finance reconstruction was undisputed; the total cost of the earthquake was estimated at USD 30 billion.<sup>90</sup> However, many economists, business leaders, and politicians on the right asserted that financing could be achieved without recourse to tax increases, through measures including international and domestic borrowing, use of revenue from the copper stabilization fund, and budgetary re-assignment; Piñera's proposal did in fact rely heavily on these and other options. That the reform package contained not only tax increases, but also tax increases targeted at business and upper-income individuals, may seem particularly unexpected given the analysis in this

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<sup>85</sup>Piñera's program of government had included the following assertion: "Definitivamente vamos a considerar el tema tributario y dentro de ello quiero dejar bien en claro que no vamos a subir los impuestos, sino que vamos a tender a darles un alivio tributario a los pequeños y medianos empresarios y a las personas." *El Mercurio*, April 23, 2010: "Impuestos: las definiciones de las autoridades económicas antes de llegar al Gobierno."

<sup>86</sup>In response to Frei's decision to include increasing the copper royalty (Chapter 4 Part 3) in his own campaign platform, Piñera did state that if a tax reform were necessary, it would be designed to leave small businesses and individuals unaffected. *El Mercurio*, Dec. 23, 2009: "Frei hace gesto a ME-O y Arrate e incluye reforma tributaria en su programa."

<sup>87</sup>The package included an increase in tobacco taxes, with the Lagos administration had attempted to legislate three times without success. Even more surprisingly, the package included a temporary property tax increase for the highest-valued 5% of homes. The Concertación had proposed a similar measure without success in 1999. In another unexpected move, the administration proposed increasing the copper royalty legislated in 2005 (Chapter 4, Part 3).

<sup>88</sup>*La Tercera*, April 16, 2010: "Piñera anuncia alza de impuestos a empresas, tabaco, royalty y venta de activos del Estado."

<sup>89</sup>See for example *El Mercurio*, April 17, 2010: "Es un plan serio, bien meditado y construido," by Eduardo Aninat.

<sup>90</sup>*El Mercurio*, March 12, 2010: "Financiar la reconstrucción, la primera tarea de Larraín en Hacienda."

chapter; business's instrumental power with respect to the executive branch increased with the right's ascent to the presidency, and business's low-tax preferences had not changed significantly from previous years. Conflict within the Alianza and even within Piñera's cabinet reinforced the fact that the tax increase ran counter to the right's ideological convictions and its policy track record. While the more moderate wing of the UDI and the RN expressed support for the government's proposal from the beginning, influential UDI politicians including Senator Jovino Novoa and party president Juan Antonio Coloma publicly objected to the idea of increasing the corporate tax.<sup>91</sup> Piñera's Economy Minister Juan Andrés Fontaine also reportedly opposed the measure while the financing proposal was being drafted.<sup>92</sup> According to one report, Finance Minister Felipe Larraín was not enthusiastic about the measure at the outset either;<sup>93</sup> he had been known for his position that the low corporate tax rate was critical for promoting investment (Cerdeña and Larraín 2005).

Three factors that are consistent with the theoretical analysis in this chapter help explain the 2010 reform proposal. First, Piñera's need to consolidate support from the broader public and legitimate his presidency, in the context of damaging criticisms from not only the Concertación, but also from within the governing coalition regarding his conflicts of interest, drove the administration to deviate from the immediate interests of its core constituency, as right had occasionally done in the past. Second, the extraordinary context of national disaster and perhaps also the presence of a party sympathetic to business interests in the executive branch disposed business to accept non-trivial short-term costs, as in 1990, clearing the way for the administration to move forward with the corporate tax increase. Third, while business's instrumental power via partisan linkages had increased with respect to the executive branch, instrumental power had decreased in congress thanks to a Concertación majority in the Senate; concessions such as a corporate tax increase could be necessary to secure the center-left coalition's votes on other measures in the financing package that reflected business and the right's policy preferences.

The corporate tax reform proposal appears to have been motivated in large part by the new administration's desire to counteract political damage incurred by accusations of conflicts of interest given Piñera's status as both Chile's wealthiest businessman and its top public official. The Concertación had long endeavored to discredit Piñera by denouncing the marriage of money and politics that his presidential candidacy allegedly represented.<sup>94</sup> Forbes estimated Piñera's net worth at USD 2 billion; his vast holdings included a 26% share in the airline LAN as well as ownership of the television station Chilevisión.<sup>95</sup> Piñera responded to the Concertación's accusations of conflicts of interest during the presidential campaign by promising to sell his shares in LAN before assuming the presidency. This process commenced before the earthquake; however, the sale of Piñera's remaining 11% holding was postponed until after he had taken office. The manner in which Piñera divested of these remaining LAN shares incurred further censure; the Concertación charged that Piñera had opted to sell his entire holding company for the express purpose of minimizing his tax obligations. PDC Senator Zaldívar directly charged Piñera not only of avoiding taxes amounting to USD 50 million,<sup>96</sup> but also of incurring a major conflict of interest given that as president, Piñera had appointed the new head of the tax agency who would be in charge of auditing the operation.<sup>97</sup> Criticisms arose from within the right coalition as well regarding Piñera's handling of his assets. RN president Carlos Larraín lamented that Piñera's failure to divest of LAN much earlier had been a serious political mistake:

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<sup>91</sup>*El Mercurio*, March 30, 2010: "Presidente de la UDI se suma a rechazo a subir impuestos para financiar la reconstrucción," *El Mercurio*, April 18, 2010: "Jovino Novoa y su crítica al alza de impuestos anunciada por Piñera."

<sup>92</sup>See for example *La Tercera*, April 16, 2010: "Piñera anuncia hoy en VIII Región paquete de alza de impuestos."

<sup>93</sup>Ibid.

<sup>94</sup>See for example *BBC Mundo, Cono Sur*, Feb. 6, 2011: "El presidente electo de Chile, Sebastián Piñera es acusado de mezclar política y negocios," *El Mercurio*, April 16, 2010: "Las claves que marcaron el análisis de la modificación tributaria."

<sup>95</sup>*BBC Mundo, Cono Sur*, Feb. 6, 2011: "El presidente electo de Chile, Sebastián Piñera es acusado de mezclar política y negocios."

<sup>96</sup>*El Mostrador*, March 22, 2010; "Por qué Piñera no vende aún las acciones de LAN."

<sup>97</sup>*El Mostrador*, March 24, 2010: "Senador Zaldívar apunta a elusión tributaria de Piñera por venta de acciones de LAN." See also *El Mercurio*, March 28, 2010: "'Éste es el Gobierno de mayor confusión entre los intereses públicos y privados,'" and *El Mercurio*, March 27, 2010: "Julio Pereira, nuevo Director del Servicio de Impuestos Internos."

El tropezón más fuerte es que no se haya hecho la venta de LAN antes de la elección. Eso le ha dado pretextos a la oposición para atacar no sólo al gobierno sino la persona moral de Sebastián Piñera. ... Yo fui partidario de que vendiera hace mucho tiempo... No ocurrió antes de la campaña que era cuando debió ocurrir. Si hubiese pasado, Sebastián Piñera habría ganado por medio millón de votos o más.<sup>98</sup>

The controversy surrounding Piñera's assets continued throughout April 2010.<sup>99</sup> RN Senator Allamand repeatedly called on Piñera to sell Chilevision, joining the Concertación in pointing out conflicts of interest with presidential appointments to TVN, the state-owned television network, and the *Consejo Nacional de Televisión*, the state agency charged with regulating television services: "No hay nadie en la Coalición por el Cambio que crea que es razonable, o posible o incluso que es legal que el Presidente Piñera mantenga la propiedad de Chilevisión;"<sup>100</sup> the UDI's political commission also pressed Piñera to take action.<sup>101</sup>

In this context, increasing the corporate tax rate could counteract the political damage already incurred by signaling to the nation that Piñera's government would not be a government of and for big business and wealthy entrepreneurs, a class to which the president himself clearly belonged. This logic reportedly motivated Piñera's Minister of the Interior to advocate the corporate tax increase and was openly expressed by other advocates of the measure, including UDI Senator Matthei.<sup>102</sup> The popularity of the corporate tax increase lent force to these arguments; a survey conducted by *El Mercurio* found 74% support among respondents in Santiago.<sup>103</sup> Piñera, who had been a leading figure in engineering RN support for the 1990 corporate tax increase with the goal of winning support from Chile's political center, was likely quick to recognize the potential political advantages to proposing another corporate tax increase in the aftermath of the 2010 earthquake.

Business, the right's core constituency, gave the government a green light to move forward with the reform proposal, which was publicly announced on April 16. The government consulted with leaders of the business associations and the largest economic groups in Chile regarding the corporate tax increase in mid-March. Although business representative clearly stated that they did not like the corporate tax increase and believed the costs of the earthquake could be financed entirely through other means,<sup>104</sup> the president of the CPC maintained: "La postura nuestra es respaldar lo que determine el Presidente;" the head of the Matte group made similar statements.<sup>105</sup> The CPC's acceptance of the 2010 tax increase paralleled its position with respect to the 1990 tax increase. Both of these reforms took place under extraordinary circumstances that made increased spending imperative. In 1990, business accepted a corporate tax increase for the sake of legitimating the neoliberal model after the transition to democracy, in a context of pent-up social spending needs inherited from the dictatorship; in 2010, business compromised in a time of dire social needs imposed by a natural disaster. That the government in 2010 was of the political coalition most businesspeople preferred may have contributed to business's

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<sup>98</sup>*El Mercurio*, March 29, 2010: "Carlos Larraín y el financiamiento de la reconstrucción."

<sup>99</sup>See for example *El Mercurio*, April 13, 2010: "Ex presidentes critican a Piñera y condicionan apoyo opositor a plan de reconstrucción."

<sup>100</sup>*El Mercurio*, April 13, 2010: "Personas tendrán beneficio tributario por donaciones a proyectos de reconstrucción."

<sup>101</sup>*La Tercera*, April 19, 2010: "UDI pedirá en comité político que Piñera se desligue pronto de CHV."

<sup>102</sup>Matthei asserted: "es una señal política potente que neutraliza el temor o los rumores que vienen desde la Concertación de que Sebastián Piñera iba a ser el Gobierno de las grandes empresas;" likewise, a source within the government asserted "Hace rato que la discusión excedió el ámbito meramente técnico y se trasladó al político." *El Mercurio*, March 30, 2010: "Presidente de la UDI se suma a rechazo a subir impuestos para financiar la reconstrucción." Meanwhile, UDI hardliner Novoa complained about the administration's "percepción equivocada de que hay que separarse de los empresarios." *El Mercurio*, April 18, 2010: "Jovino Novoa y su crítica al alza de impuestos anunciada por Piñera." See also *El Mercurio*, April 16, 2010: "Las claves que marcaron el análisis de la modificación tributaria," *La Tercera*, April 16, 2010: "Bachelet: 'No aceptamos la concepción de poder que mezcla la política y los negocios.'"

<sup>103</sup>*El Mercurio*, April 11, 2010: "Encuesta: aumento de impuestos a las empresas obtiene 74,4% de respaldo."

<sup>104</sup>See for example *El Mercurio*, April 16, 2010: "Empresarios piden al Gobierno entregar plan de financiamiento y acelerar reconstrucción."

<sup>105</sup>*El Mercurio*, March 30, 2010: "Presidente Piñera analizó el plan de reconstrucción con la CPC," *El Mercurio*, April 15, 2010: "Matte manifestó que si es necesario, habría que apoyar un incremento de impuestos, pero que fuese de carácter transitorio."

willingness to compromise;<sup>106</sup> it was reasonable to expect that the government's future policies would advance business interests. This logic is similar to Timmons (2010) argument that it is easiest for governments to tax their own supporters; right governments can tax corporations more heavily because they can more credibly commit to providing benefits for these taxpayers than can left governments. However, business would likely also have accepted tax increases had the Concertación remained in power. Refusing to contribute through taxation in the aftermath of a major natural disaster could have damaged business's public image and may have fueled anti-business sentiments within the Concertación and the broader public.<sup>107</sup> Business likely recognized the importance of compromise under these extraordinary circumstances for protecting its long-term interests, as it had in 1990.<sup>108</sup>

Government reform strategies pioneered by the Concertación (Chapter 4) reinforced the logic of business acceptance discussed above and helped the Piñera administration consolidate acquiescence to the corporate tax increase. First, the administration attenuated the impact of the tax increase by ensuring that it would be temporary; the proposal scheduled a gradual return to the prevailing 17% rate in 2013. Business leaders cited the transitory nature of the tax increase as critical to their acceptance.<sup>109</sup> Second, the financing package included compensations for big business: expanded tax benefits for corporate donations, which business had long advocated,<sup>110</sup> and a version of the same accelerated depreciation measure that the Bachelet administration had proposed in 2006 to stimulate investment.<sup>111</sup> Plans to privatize a few state assets likely also appealed to business. Third, the tax increases were linked to spending for the sake of national reconstruction. The administration emphasized that tax revenue would fund expenditure on health and education in regions harmed by the earthquake.<sup>112</sup> The strong benefit-side legitimacy of the tax increase helped elicit pledges of support from business. For example, the president of Asimet, the metallurgical industry association, "indicó que la responsabilidad de los empresarios frente a la reconstrucción del país los mueve a apoyar las medidas propuestas, sobre la base de que serán transitorias."<sup>113</sup>

The corporate tax increase may also have been motivated by one final factor: the Concertación's majority in the senate, which reduced business' instrumental power in congress. The center-left coalition had lost the presidency and control of the lower house, but it won 20 out of 38 seats in the senate, whereas the right coalition secured only 16 seats. Even if the two independent senators voted with the right, the Concertación's solid if slim absolute majority would allow it to block legislation. Including a corporate tax increase, a measure long advocated by the Concertación, could help to secure the opposition's support for the financing package, which contained several measures the Concertación was expected to resist. Among these potentially problematic measures were the reforms to expand tax credits for donations, which Concertación technocrats had long rejected, privatizations of state assets including an electric

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<sup>106</sup>A survey of 330 business executives in November 2009 found high support for Piñera. 95% of respondents chose Piñera as the best candidate from the perspective of promoting economic growth, and 88% chose Piñera as the best candidate for promoting the interests of the respondent's business or sector. *El Mercurio*, Nov. 14, 2009: "Encuesta de la Escuela de Negocios de la Universidad de los Andes, ESE, y El Mercurio."

<sup>107</sup>*El Mercurio*, April 19, 2010: "Las claves que marcaron el análisis de la modificación tributaria."

<sup>108</sup>The mining sector had learned this lesson more recently in the aftermath of the 2005 copper royalty. An informant from the sector lamented the copper mining companies' previous lack of attention to public relations and explained that they were currently taking measures to portray the copper sector as a vital contributor to the national wellbeing (Mining Sector D 2005, author's interview).

<sup>109</sup>*Diario Financiero*, April 16, 2010: "CNC califica de 'innecesaria' alza de impuestos," *El Mercurio*, April 17, 2010: "La autoridad pretende recaudar US\$ 700 millones adicionales," *El Mercurio*, April 21, 2010: "Gobierno informó hace más de un mes al sector privado alza tributaria."

<sup>110</sup>These benefits were included in a reform to the Ley de Donaciones sent to congress in advance of the financing package on April 10, 2010.

<sup>111</sup>*El Mercurio*, April 17, 2010: "Felipe Larraín defiende alzas tributarias: 'Es necesario que todos contribuyamos,'" *La Tercera*, April 17, 2010: "Felipe Larraín, ministro de Hacienda: 'Sin terremoto no habría habido alza tributaria.'"

<sup>112</sup>*El Mercurio*, April 19, 2010: "Gobierno despliega estrategia para asegurar aprobación de proyectos para reconstrucción."

<sup>113</sup>*El Mercurio*, April 21, 2010: "De Gregorio sale en defensa de las fuentes de financiamiento del plan de reconstrucción."

energy plant owned by Codelco, and accelerated depreciation.<sup>114</sup> PPD Senator Girardi and PS Senator Letelier announced before the administration had finalized the contents of the financing package that they would condition their support for the donations reform on inclusion of a corporate tax increase.<sup>115</sup> In sum, just as business' strong instrumental power in congress had motivated the Lagos administration to include personal income tax cuts with the 2001 corporate tax increase, weakened instrumental power in congress may have encouraged the Piñera administration to include the corporate tax increase along with non-tax funding measures in the 2010 financing package.

It is certainly too early to provide a full analysis of the 2010 reform proposal; debate in congress remained pending when this dissertation was filed. Further research on this case in the future will provide additional insights into the formulation of Piñera's tax agenda and on the changes and continuity in business-right relationships.

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<sup>114</sup>In order to secure quick approval for the financing package, Piñera in fact removed the accelerated depreciation provision from the proposal before sending it to Congress on May 5, 2010, due to the Concertación's strong opposition and threats to reject the measure. *La Tercera*, May 5, 2010: "Gobierno modifica plan de financiamiento."

<sup>115</sup>*El Mercurio*, April 15, 2010: "Álvarez defiende ley de donaciones ante críticas sobre su escaso aporte." On Hernán Büchi's assessment that the corporate tax increase was included to "tener algo armónico con la oposición" given the need to votes in congress, see *La Tercera*, April 15, 2010: "Hernán Büchi: 'Me preocupa que en poco más de 20 días cedamos a la presión de subir los impuestos.'"



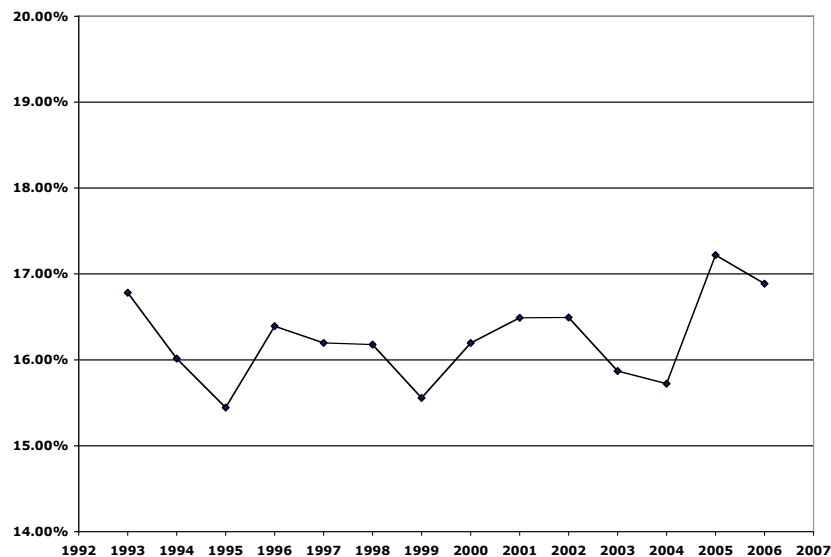
## Chapter 4. Incremental Tax Increases in Chile: Executive Strategies, Business and Legislator Responses, and Reform Outcomes

### Introduction

Although strong instrumental power kept significant corporate tax increases off of the agenda in Chile, the center-left Concertación coalition that occupied the executive branch from 1990-2010 developed a broad repertoire of strategies that facilitated incremental revenue-raising reforms in other tax policy areas. Meanwhile, continuity in power allowed the Concertación to bide its time and seize opportune moments for reform when they arose. In fact, several tax reform goals devised by Concertación technocrats in the early 1990s were finally achieved in the mid-2000s, although progress on other fronts remained minimal as of 2010.

This chapter examines the tax reform agenda and the fate of reform proposals initiated in five tax policy areas. The analysis of each policy area demonstrates the key role played by business's instrumental power in restricting the tax reform agenda, although concerns over structural power occasionally contributed as well. Further, the case studies elucidate the potential and the limitations of tax-side and benefit-side reform strategies. Overall, while these strategies were critical for increasing taxation, the political space they created for reform proved quite narrow, given business's strong instrumental power. Although incremental tax increases provided much-needed additional resources, total tax revenue did not increase substantially from 1992-2006 (Figure 4.1);<sup>1</sup> revenue increases thereafter were due largely to the exogenous boom in international copper prices, which swelled the tax base. Before proceeding to the case studies, I provide an overview of the Concertación's strategy repertoire and the strategic environment in which the executive operated.

Figure 4.1: Total Tax Revenue in Chile, % GDP, 1993-2006



### The Concertación's Strategy Repertoire

The Concertación developed a stable repertoire of tax-side strategies (attenuating impact and legitimating appeals) and benefit-side strategies (emphasizing fiscal discipline, compensation, and linking to social spending) to manage opposition from business and the right. Several of these strategies also

<sup>1</sup>The absence of a steady upward trend in tax revenue despite the incremental increases discussed in this chapter is due partly to simultaneous reductions of trade taxes and other taxes that Concertación policymakers deemed inefficient.

served to consolidate support within the governing coalition itself; divisions between the more conservative wing and the left wing of the coalition occasionally threatened discipline on tax issues. Many of these reform strategies were employed in Chile as early as 1964 under the reformist government of Christian Democrat Frei Montalva (Ascher 1984: 128-131). I provide below an overview of these strategies and explain the factors underpinning their potential for success as well as factors that can limit their effectiveness in the Chilean context. Some strategies have become less effective if not less frequently employed over time, while others have become increasingly potent due to the changing nature of electoral competition with the right. In general, the Concertación made use of multiple reform strategies when advancing any particular tax increase (Figure 4.2).

### ***Attenuating Impact***

Attenuating impact was a regularly employed Concertación tax-side strategy. Administrations pursued incremental reform, gradually increased tax rates and broadened tax bases when feasible, in accord with President Aylwin's dictum from the early 1990s that reform should be undertaken "en la medida de lo posible."<sup>2</sup>

At the level of reform design, administrations have used two techniques to attenuate impact: phase-ins and "temporary" reforms. Phase-ins entail gradual implementation. For example, a two-point tax rate increase could be implemented in half-point increments over a four-year interval, or a base-broadening measure could be scheduled to take effect three years after its approval in Congress. Phase-ins give business a transition period to adjust their plans to tax increases or to finish projects that were already under way before the tax rules change. Consequently, phase-ins help to reduce business opposition. They can also neutralize arguments based on structural power, since they are designed to have a minimal impact on investment decisions. The second technique entails legislating a tax increase for a delineated period of time, after which the pre-reform tax legislation will go back into affect. This technique was used in the 1990 reform; making the corporate tax increase temporary helped to get the reform past business and the right, and the Concertación was later able to make the tax increase permanent (Chapter 4). In fact, every time the Concertación legislated a temporary tax increase, it has later renewed the reform or made it permanent. Renegotiating reforms that have already been in affect for several years is generally easier than passing the reform the first time around. Variants of this technique, to which Ascher (1984: 131) refers as a "foot in the door" strategy, were also employed in Chile by President Frei Montalva in the 1960s.

While techniques that attenuate impact have helped the Concertación extract more revenue from economic elites, business and the right became quite aware of this strategy over time and therefore tended to resist even marginal tax increases, based on the argument that the cumulative affects are non-trivial. This dynamic was particularly evident during Lagos' term in office. A former General Manager of the CPC explained the business sector's resistance to even minor tax increases as follows:

Lo que pasó con muchos gobiernos de la Concertación, es que si uno analiza una ley concreta, o una parte de una ley, por si sola no tiene un gran impacto, pero si uno va sumando una ley aquí seis meses después otra ley, seis meses después otra ley, otra y otra ...al final, por supuesto termina impactando sin duda. (Urenda 2007, author's interview)

Likewise, marketing reforms as "temporary" became less effective over time, given that business and the right anticipated that the Concertación would try to make all such reforms permanent in the future. Accordingly, these actors sought to prevent reforms from passing in the first place.

### ***Tax-Side Legitimizing Appeals***

The Concertación also made ample use of tax-side legitimating appeals. Appeals based on nationalism in the case of copper mining and appeals based on vertical equity had the potential to pressure

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<sup>2</sup>Aylwin used this phrase with reference to his circumscribed pursuit of justice for military officials following the transition to democracy. *El País*, Jan 2, 1991: "Aylwin reitera que investigará a fondo la violación de los derechos humanos en Chile."

right legislators to accept tax increases, given widespread support for these principles among Chileans. A survey conducted by the *Centro de Estudios de la Realidad Contemporánea* (CERC 2004) found that 67% of citizens favored taxing the private mining sector more heavily, while only 15% disapproved. Likewise, in a survey conducted by the *Centro de Estudios Públicos* (CEP 2000), 52% of respondents indicated that individuals with high incomes should pay a much larger proportion of their income in taxes than low-income individuals, and 23% indicated that high-income individuals should pay a larger proportion. In contrast, only 17% responded that upper income individuals should pay the same or a lower proportion than low-income individuals.

Equity appeals tended to be most effective for pressuring the right when reforms were initiated in close proximity to presidential elections, such that voters would be more likely to remember politicians' policy positions in the polling booths. Vertical equity appeals became more effective during Lagos' term when public debate over income inequality assumed a higher public profile. Competition from the right on the issue of inequality during the 2005 electoral period provided a special opportunity for the Concertación to employ this strategy.

Vertical equity appeals were also important for aligning Concertación legislators behind executive tax proposals. On the one hand, vertical equity appeals helped secure support from the left wing of the Concertación. To this end, the executive cleverly used vertical equity appeals to promote even tax increases that strictly speaking were regressive, such as the 2003 VAT increase.

On the other hand, targeting tax increases at upper-income sectors helped to secure support from the Christian Democrats, who were particularly vulnerable to business and the right's strategy of framing tax increases as harmful to the middle class. During the 2000s in particular, the Christian Democrats were engaged in electoral competition with the UDI to represent "middle class" sectors (Navarette 2005: 129, Boeninger 2005: 25, author's interviews).<sup>3</sup> Consequently, campaigns denouncing tax increases as burdening small and medium businesses or working professionals could be quite effective for defeating tax reforms. The possibility that Christian Democrats and other legislators from the conservative wing of the Concertación might side with business and the right against the executive's tax proposals was a frequent concern for Finance Ministry technocrats.

Appeals based on horizontal equity, a principle espoused at least rhetorically by business in Chile, have helped reduce business-right opposition primarily in the case of anti-evasion reforms. Reforms that enhance horizontal equity by eliminating sector-specific tax benefits largely failed to mitigate business opposition, given strong business cohesion and solidarity in opposition to tax increases.

### ***Obfuscating Incidence***

Obfuscating incidence is the only strategy that has not been relevant for managing opposition to tax increases in Chile. The Concertación often opted to broaden tax bases instead of increasing tax rates, and this approach can be considered a technique for reducing visibility—rate increases more clearly signal that taxpayers will bear a higher burden. However, elites were well aware that base-broadening reforms in practice increase their tax burden, so this approach in and of itself did not reduce opposition from business and the right. A number of base-broadening reforms were legislated, but the executive used appeals to horizontal and vertical equity to manage opposition in these cases.

### ***Emphasizing Fiscal Discipline***

Emphasizing fiscal discipline—a variant of emphasizing stabilization relevant in a context of remarkable economic and political stability—was a consistent feature of tax politics in Chile from 1990 to 2010. During the transition to democracy, business and the right were concerned that the Concertación would engage in irresponsible spending, which was deemed a major cause of the economic problems of the Allende period. Pointing out that higher tax revenue was essential for maintaining fiscal discipline,

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<sup>3</sup>Boeninger (2005: 25) described "middle-class" sectors as a "natural enclave of support" for the PDC. See also Adolfo Zaldívar, "Urge dar un respiro a la paciente clase media," Jan. 12, 2005. Senado, Departamento de Prensa, Santiago. [www.senador.cl/prontus\\_senado](http://www.senador.cl/prontus_senado) Accessed April 9, 2009.

given increased demands on government resources in the context of democratization, was critical for passing the 1990 tax reform and making those tax increases permanent in 1993. After 2005, however, emphasizing fiscal discipline became a less effective strategy due to the context of record fiscal surpluses associated with high copper prices (Chapter 3, Section V).

The Concertación almost always coupled emphasis on fiscal discipline with either linking to social spending or elite compensation. In fact, linking tax increases to social spending requires either tacitly or explicitly making the case that expanded spending is acceptable only if new resources can be generated to finance it. The same observation holds in the case of compensations for elites that entail fiscal cost, such as reducing other taxes.

### ***Compensations***

Reform packages have often included compensations for business and/or the right as a means to reduce opposition to tax increases. In extreme cases, compensations made the proposed overall reform package revenue-neutral, whereas in other cases the compensations offered entailed limited fiscal costs. Compensations directly associated with tax increases have included formal or informal tax invariability agreements and reductions of other taxes.

### ***Linking to Social Spending***

Linking tax increases to social spending has a long history in Chile and has been one of the most widely employed reform strategies following the transition to democracy. President Frei Montalva frequently employed this strategy in the 1960s (Ascher 1984: 129-130). Linking to spending played a key role in forging support for the 1990 tax reform (Chapter 3, Section IV) and was employed in every tax increase since 1990, with only two exceptions. Informants from the Lagos administration and prior Concertación administrations consistently expressed the view that tax increases were feasible only when the executive could argue that a particular program or programs require funding (author's interviews: Eyzaguirre, Marcel 2005, Marfán 2005, Arellano 2005, Finance Ministry B 2005). According to Former President Lagos (2006, author's interview): "la clave en una reforma tributaria [es] vincularlo al destino de los fondos. Yo nunca quise discutir la reforma tributaria, yo discutía qué hace con la plata." Similarly, a Finance Ministry informant from the Aywlin and Frei administrations maintained: "...tu discutas en el mismo paquete los proyectos publicos y el financiamiento. Forma parte de lo mismo, no son cosas separados. ...Es un elemento muy clave," (Marfán 2005, author's interview).

The Concertación used three techniques for linking tax increases to spending. In some cases, links were based primarily on discourse. For example, proposal texts and government officials explained that the tax increase was needed to fund expanded social spending. Discourse alone creates the weakest links between taxing and spending. A second, stronger technique entailed formally including new spending programs with tax increases in the same legislative proposal, forcing both aspects to be debated at the same time and making the links more apparent as described above by Marfán. Even tighter links could be created by making spending initiatives contingent on approval of the tax increase. This third technique was possible because the executive branch in Chile has the privilege of exclusive initiative on tax reforms—only the executive can propose or amend a tax bill. While legislators can approve or reject measures in a tax bill, they cannot change the text of an article. Consequently, the executive could word a proposal such that if the tax increase were rejected, the spending program to be funded would not take effect.<sup>4</sup> In the absence of exclusive initiative, contingency would not be possible; legislators could simply introduce their own modifications to the proposal and pass the spending measures but not the tax increases. Contingency allows for the tightest possible linking to social spending or popular benefits in Chile, given that earmarking is prohibited by the constitution.

Linking to social spending can be an effective strategy for reducing opposition from the right for two reasons. First, there tends to be more consensus between the left and the right in Chile on social

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<sup>4</sup>This end is usually accomplished by including an article that stipulates that the spending program will commence as soon as or the month after the tax increase takes affect.

spending than on taxation. The Pinochet regime pioneered targeted spending during the dictatorship, partly to generate a base of popular support (Etchemendy 2004: 304-310, 314-315), and the Concertación subsequently adopted and expanded that model (Castiglioni 2005). Second, right-party legislators can feel electoral pressure to support popular programs. Especially in cases where the spending program is popularly viewed as or can easily be framed as highly justified on the basis of equity or morality, like increasing pensions for the elderly poor, opposing a tax increase linked to spending can be politically damaging. Several right-party and business informants acknowledged that linking to spending made it more difficult to oppose tax increases (author's interviews: Alvarez 2005, Urenda 2007, Ariztía 2005). For example, an UDI deputy commented: "Sí tiene impacto político, una gran capacidad del gobierno de decir: 'no estos señores no quieren mejorar los proyectos sociales y no dan ni dinero para eso' ... nos daña ... el cuento, por así decirlo, la historia que logra involucrar al gobierno, sí nos daña," (Alvarez 2005, author's interview).

However, the effectiveness of linking to social spending, as well as tax-side legitimating appeals that are designed to put popular pressure on opposition legislators to approve reform, is limited by characteristics of electoral competition in Chile. Luna (2006) argues that legislators from the right parties, and to a lesser extent the Concertación as well, win votes from the popular sectors not because of their policy positions, but thanks to small-scale, district level clientelism. Consequently, the right has the potential to win votes from the beneficiaries of social spending programs even if the government attempts to frame rejection of tax increases as rejection of those programs. In addition, the right had no shortage of arguments with which to defend their opposition to tax increases even when linked to social spending. For example, business and the right increasingly maintained that social spending should be funded through improved efficiency, reallocation, privatization, or simply economic growth.

## Chapter Overview

The remainder of this chapter is organized into five sets of case studies that include the major revenue-raising and/or equity-enhancing tax reforms pursued by the Lagos and Bachelet administrations,<sup>5</sup> as well as antecedent proposals or reforms undertaken by previous administrations. The analysis of these cases demonstrates the key role played by business's instrumental power in restricting the reform agenda, although concerns over structural power and other constraints occasionally contributed as well. In each case, I illustrate how constraints and strategic considerations shaped the executive's tax policy choices and the timing of reform initiatives. The case studies elucidate both the potential and the limitations of tax-side and benefit-side reform strategies in a context of strong business power. The case studies also illustrate the political tradeoffs the executive faced in seeking to fulfill three often mutually incompatible goals: meeting revenue targets, minimizing conflict with business and winning votes from the right, and maintaining discipline within the Concertación. Success on these different fronts varied across reform episodes.

Part 1 analyzes the 2001 Anti-Evasion reform, which constituted a major revenue-raising success in the Chilean context, second only to the 1990 reform. The design of the Anti-Evasion reform facilitated appeals to both horizontal and vertical equity. Tax-side equity appeals did not preclude high levels of conflict with business and the right or dissent within the governing coalition. However, these strategies were critical for maneuvering the reform through Congress during a period characterized by belligerent business-right opposition to the administration. Although the executive was forced to negotiate the details of the reform directly with business and the right, the concessions inflicted a relatively moderate loss of anticipated revenue.

Part 2 analyzes the strategy of linking to social spending to facilitate passage of regressive tax increases. The Concertación frequently resorted to raising revenue with indirect and/or regressive taxes due to constraints imposed by business's instrumental power. VAT increases, for example, incurred little

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<sup>5</sup>I exclude several municipal tax reforms, which are legislated by the national government. A brief overview of these cases is included in Fairfield (2006) and Sabaini et. al. (2006: 59-61). Discussion of the 2001 corporate tax increase is incorporated in Chapter 3.

business opposition. However, regressive tax increases stimulated conflict within the Concertación and created political opportunities for the right to attack the government. Linking to social spending helped the executive maintain internal discipline and secure enough non-Concertación votes to pass indirect tax reforms during the Frei and Lagos administrations. However, the reforms analyzed in this section provide evidence that although Concertación policymakers felt that linking to social spending was necessary for passing tax increases, this strategy was not always sufficient for winning right party votes or minimizing debate over taxation.

Part 3 analyzes a series of Concertación efforts to address the problem of under-taxation in the mining sector beginning in the early 1990s and culminating in the 2005 with the passage of a “specific tax” on mining. Strong tax-side legitimacy based on nationalist convictions that copper wealth belonged to the Chilean people created political space for reform after 2002. The pre-electoral timing of the 2005 proposal contributed to the success of the specific tax; a similar reform proposal had been defeated by the right in 2004. However, the political space created by inherent legitimacy was quite restricted. The 2005 reform was modest in terms of its anticipated revenue-raising capacity and impact on the mining sector. And despite the reform’s overwhelming popularity, it entailed a major, extended political battle with business and the right. In addition, the reform came at the cost of precluding further tax increases on the mining sector for the next decade.

Part 4 examines another tax-side legitimating appeal success. In the context of electoral competition on the issue of inequality initiated by the UDI’s presidential candidate in 2005, Concertación appeals to vertical legitimacy compelled the right to vote in favor of eliminating a notorious tax benefit for the rich known as “57 bis,” despite the fact that business and the right had consistently defended the tax benefit since 1990. This reform was of significant symbolic importance, despite the fact that the revenue it produced was minimal. This reform episode is remarkable not only for the effectiveness of the vertical equity appeal, but also for the administration’s reluctance to pursue the opportunity further. Non-action on other tax issues in the aftermath of this reform reflects in part the remarkable strength of business’s instrumental power in Chile.

Part 5 analyzes the Bachelet administration’s attempt to restrict the use of another regressive tax benefit—a VAT credit that subsidized the construction sector and upper-income home-buyers—through appeals to vertical equity and contingent linking to benefits demanded by business and the right. As in other cases examined, the executive’s mix of strategies helped to create political space for a reform that otherwise would have had little hope of passing in congress. But once again, that political space proved quite narrow. Opposition from the right and the construction sector, which helped create dissent among PDC legislators concerned with protecting the “middle class,” forced the executive to target the effective tax increase at a tiny fraction of upper-income consumers. These concessions significantly curtailed the revenue-saving potential of the VAT credit modification, leaving the cost of the other benefits included in the reform package uncompensated.

Figures 4.2 and 4.3 provide an overview of all revenue-raising and/or equity-enhancing tax reforms legislated in Chile from 1990 to 2010.<sup>6</sup> Figure 4.2 displays the strategies employed by the executive for each proposed reform. Figure 4.3 displays the expected revenue-capacity for each reform and the extent to which the executive secured its initial revenue target.

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<sup>6</sup>This list of reforms was compiled based on expert opinions from executive branch informants, business leaders, and independent economists, as well as analysis of Finance Ministry reports.

**Figure 4.2: Revenue-Raising and / or Equity-Enhancing Tax Increases, 1990-2008.**

CIT = Corporate Income Tax; PIT = Personal Income Tax; VAT = Value-Added Tax.

Most important strategies for each reform displayed in bold.

Reform		TAX-SIDE STRATEGIES		BENEFIT-SIDE STRATEGIES		
		Attenuating Impact	Legitimizing Appeals	Compensation	Emphasizing Fiscal Discipline	Linking to Social Spending or Popular Benefits
Aylwin	1990: CIT, PIT and VAT Increases	Temporary	Vertical Equity	No direct tax increases for 4 years.	<b>Finances Spending</b>	<b>Discursive*</b>
	1993: Made 1990 CIT Increase Permanent			<b>Top PIT rate cuts; No direct tax increases for four years.</b>	<b>Preventing Fiscal Deficit</b>	
Frei	1995: Excise Tax Increases		Vertical Equity		Finances Spending	<b>Contingent:</b> Pension Increases
	1997: Made 1990 VAT increase permanent				Finances Spending	<b>Inclusion:</b> Education reforms (full school day)
	1998: Anti-Evasion Reform		Horizontal & Vertical Equity	Savings Incentives for business and individuals	Finances Spending	<b>Contingent:</b> Pension increases
Lagos	2000: Anti-Evasion Reform	Phased-In	<b>Horizontal &amp; Vertical Equity</b>	Sumptuary Tax Reductions, Capital Gains Tax Exemptions	Finances Spending	Discursive: Lagos' program of government generally
	2001: CIT Increase	Phased-In		<b>Top PIT Rate Cuts: Revenue-Neutral Reform</b>	<b>Finances Compensations</b>	
	2003: VAT Increase, Excise Taxes	<b>Temporary, Phased-in</b>	Vertical Equity	Tariff Reductions (legislated separately)	<b>Finances Compensations and Spending</b>	<b>Discursive:</b> Health care reform, targeted social spending programs
	2005: Mining Tax	Phased-In	<b>Nationalism</b>	<b>Tax Invariability Clauses</b>		
	2005: Eliminated 57 bis		<b>Vertical Equity</b>		Finances Spending	<b>Inclusion:</b> Scholarships for low-income students
Bachelet	2006: Made 2003 VAT increase Permanent				Finances Spending	<b>Contingent:</b> Pension increases
	2008: Restricted VAT benefit for constructing homes	Phased-In	<b>Vertical Equity</b>	<b>Gas &amp; Stamp Tax Cuts: Revenue-Neutral Reform</b>	Finances Compensations and Popular Benefits	<b>Contingent:</b> Gas tax cuts, stamp tax cuts for small and medium businesses

\*The 1990 reform funded pension increases, familiar allowances and subsidies, expansion of housing programs, readjustment of *subvenciones educacionales* (Marcel 1997: 55). These spending programs were not included in the tax reform package, but they were sent to congress at the same time (Marcel 1997: 56), and they were simultaneously negotiated with the right along with the tax increases. As such, the links to spending in this case were stronger than in the other cases that are scored as "discursive."

**Figure 4.3: Revenue Targets and Revenue Loss During Policy Process**

		<b>Revenue Estimate: Legislated Reform*</b> (USD million/yr and/or % GDP)	<b>Original Revenue Target**</b> (USD million/yr and/or %GDP)	<b>Revenue Loss</b> (% Original Target)
<b>Aylwin</b>	1990: CIT, PIT and VAT Increases	~2% GDP	3% GDP†	High (33%)
	1993: Made 1990 CIT Increase Permanent	Preserved ~1.4% GDP†	Preserve ~1.4% GDP†	None. (Net loss of 250†† from PIT cuts in reform package)
<b>Frei</b>	1995: Excise Tax Increases	NA	150 (~0.2% GDP)	NA
	1997: 1990 VAT increase made permanent	Preserved ~0.9% GDP†	Preserve ~0.9% GDP†	None.
	1998: Anti-Evasion Reform	NA (<0.1% GDP)	120 (~0.1% GDP)	NA
<b>Lagos</b>	2000: Anti-Evasion Reform	774 (~1% GDP)	1000††† (pre-proposal target)	Moderate (23%)
	2001: CIT Increase (revenue-neutral package)	153 (~0.2% GDP)	153 (revenue-neutral package)	None
	2003: VAT Increase, Excise Taxes	315 (~0.4% GDP)	370	Low (15%)
	2005: Mining Tax	126 (~0.1% GDP) (actual 2006 revenue: 0.5% GDP°)	142	Low (11%)
	2005: Eliminated 57 bis	21	21	None
<b>Bachelet</b>	2006: Made 2003 VAT increase Permanent	600 (~0.4% GDP)		None
	2008: Restricted VAT benefit for home construction	110-150 (but net revenue loss)	190 (revenue-neutral package)	High (32-45%)

\*Based on Finance Ministry's estimates provided during discussion of reform unless otherwise noted. Figures apply after completion of phase-ins.

\*\*Revenue estimate once phase-ins completed, for proposal sent to Congress, unless otherwise specified.

†Very rough estimates based on approximate revenue increase from 1990 CT increase (Marcel 1997: 41).

††Marcel (1997: 58) ††† Etcheberry (2005, author's interview) °Due to unanticipated copper price increases



## **Part 1. The 2001 Anti-Evasion Reform: Strategic Reform Design and Horizontal Equity Appeals Achieve Revenue-Raising Success**

In August 2000, the newly elected Lagos administration sent an ambitious reform package to Congress designed to raise revenue for expanded social spending by fighting tax evasion and tax avoidance. This reform, approved in 2001, was a major success in the Chilean context. In terms of revenue-raising capacity, the anti-evasion reform was the most significant tax reform since 1990, increasing revenue by around 1% of GDP. Moreover, the anti-evasion reform was legislated in a context that was particularly adverse for tax reform. Business and the right were especially disinclined to compromise on taxes, given business hostility toward the new socialist administration and the right's belligerence following its candidate's strong performance in the 2000 presidential election. In addition, Concertación policymakers harbored concerns about the affects that a major tax increase might have had on investment, given the sluggish state of the economy.

This section analyzes how strategic reform design and associated tax-side strategies allowed the Lagos administration to secure substantial additional revenue in 2001 despite the strong constraints imposed by instrumental power, and to a lesser extent, structural power as well. Pursuing measures to reduce evasion and control avoidance, instead of increasing tax rates, allowed the administration to make compelling moral appeals based on horizontal equity as well as vertical equity that put business and the right on the defensive. This approach did not preclude significant, extended conflict with business and the right; in fact, the political process surrounding this reform involved many of the "tax war" dynamics described in Chapter 3. However, the reform design and appeals to equity were critical for securing approval of the revenue-raising package at a time when any other tax reform would have incurred more severe conflict with business and the right, and almost certain defeat in Congress.

### **An Inopportune Context for Raising Taxes**

Tax reform promised to be a particularly difficult endeavor in 2000 given business and the right's antagonism toward the new administration as well as a slow economy. Concerns regarding business' instrumental power, and to some extent structural power as well, restricted the administration's reform agenda.

While business and the right in Chile never liked tax increases, their positions regarding tax reform were especially recalcitrant at the beginning of Lagos' term. A number of factors contributed to the right's belligerence. First, the hard-line UDI, which maintained the strongest partisan linkages to business, had made gains in the senate in 1998 parliamentary elections at the expense of the RN, its more moderate and compromise-disposed coalition partner (Silva 2002: 350). Second, the right was empowered by its strong showing in the 1999 presidential election and sought to take advantage of Lagos' relative weakness. The UDI candidate, Joaquin Lavín, had pushed the Concertación into a runoff election, the first since the transition to democracy. Lagos won the election by only 2.1 percentage points and hence took office with a weaker mandate than his predecessors.<sup>1</sup> The right hoped that strong opposition would help provoke divisions within the Concertación that would further weaken the government and improve the right's electoral prospects (Silva 2002: 350). Following a similar vein of logic, Former Finance Minister Eyzaguirre (author's interview, 2007) attributed the right's opposition to the 2001 tax reform in part to strategic calculations: "they knew that we needed the money in order to develop our program of social reforms, that that was going to give us political capital, so they would block the funding."

Business antagonism can be attributed to their leaders' support for the right's political project and lack of trust in the new administration. Prominent business leaders such as Walter Riesco had openly supported Lavin's candidacy. Likewise, Riesco's successor to the presidency of the CPC, Ricardo

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<sup>1</sup>Aylwin won with 55% of the vote in 1990, and Frei won with 58% of the vote in 1993, whereas Lagos won just 48% of the vote in the first round and slightly over 51% of the vote in the second round (Georgetown Political Database of the Americas).

Ariztía, made no effort to hide his strong preference for the right.<sup>2</sup> Further, despite ten years of Concertación government that had respected and in fact deepened the neoliberal economic model, the election of Lagos, the first socialist president since Allende, created concern among the business sector.<sup>3</sup> As the former president recalled:

Durante ese tiempo, el sector empresarial me miraba con mucha desconfianza a mi. Tenían siempre miedo que me pasara a mi la Papa—hablar en polaco. Cuando hubo un intento de asesinato al papa, el papa habló “oh my god” o algo así, pero lo dijo en polaco. Le nace el fondo de su alma. Que yo hablara en polaco quería decir que hablara como un aguerrido socialista que va a terminar con la burguesía. Entonces en el año 2000 cuando discutíamos esto, todos decían en cualquier momento, el Presidente hablara en polaco. (Lagos 2006, author’s interview)

Business leaders regularly expressed their distrust in the administration during 2000 and 2001. For example, CPC president Riesco called for Lagos to clearly demonstrate his position with respect to the neoliberal model:

Lagos tiene que definir claramente cual va a ser su posición frente a dos opciones que hoy día se bajarán: si en definitiva va a ser el camino que señaló el Presidente cuando asumió el mando ... y con esto abrir los espacios y tomar las medidas necesarias para que el sector privado se desenvuelva bien. O la otra alternativa, optar por un camino de no confiar mucho en el modelo económico y entrar a regularlo...<sup>4</sup>

Strident business opposition to tax and labor reforms also aimed to preclude more far-reaching socio-economic reforms during Lagos’ tenure. Silva (2002: 351) argues that “the CPC used their campaign against the reforms to break up key elements of the social coalition renovated socialists sought to build to support neostructuralist policy initiatives over the longer term.”

Belligerent business-right opposition in a context of strong instrumental power helped to restrict the tax agenda during Lagos’ first years in office. The administration recognized even before taking office that passing tax reform would entail a major battle with business and the right, and this realization contributed to Lagos’ decision not to increase tax rates in 2000 (Chapter 3).

Structural power also helped to restrict the reform agenda in 2000. Top policymakers were concerned that a major tax reform might have negative effects on investment and economic recovery in the context of slow growth in the aftermath of the East Asian crisis. While growth rates during the 1990s had averaged 6%, growth during the first years of the Lagos administration was anticipated to be around 3%; unemployment had increased from 4% in the 1990s to around 10% (Silva 2002: 349). As Eyzaguirre (2007, author’s interview) recalled:

The US did have a mild recession starting in the last quarter of the year 2000. ...then [there] was September 11, and then Lula appears, and then the default of Argentina. So the world economy was not growing, the risk premium in international markets was as high as ever, as high as during the Asian Crisis, so the business environment, the world economic environment, the animal spirits, were down, down, down. So it was very hard for us to go for the real stuff, that is, direct taxes.

Business’s lack of trust and antagonism toward the administration to some extent contributed to concerns regarding the impact of tax reform on investment. Lagos and Eyzaguirre felt the need to “prove” their ability to govern the economy to a wary business community, despite the Concertación’s

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<sup>2</sup>*El Mercurio*, March 18, 2001: “El pliego empresarial.” These and other business leaders also publicly supported Pinochet during his arrest in London as well as after his return to Chile in August 2000. Riesco in fact led a business delegation to visit the former dictator in London, and he asserted in an interview in December of 2000 that “los empresarios guardan un sentido de lealtad y respecto muy grande” for Pinochet. *La Tercera*, Dec. 11, 2000: “La CPC nunca ha sido un partido político,” see also *La Tercera*, Dec 17, 2000.

<sup>3</sup>While Silva (2002: 348) writes that the ascent of the renovated socialists hardly justified business’s virulent attacks against the new administration, that the renovated socialists in objective terms posed little threat to business interests and the neoliberal model does not mean that the business sector did not view the administration as a threat.

<sup>4</sup>*La Tercera*, Dec. 11, 2000: “La CPC nunca ha sido un partido político.”

excellent record over the past decade. Eyzaguirre explained that the Concertación had been “governing with good wind” and had not yet navigated a “major worldwide deceleration.” He recalled:

The economic situation began to get better when we proved that at the macro level we were very responsible, that markets were giving us credit in terms of low risk premiums... and the economy began to grow again. ...The Lagos government at the end of the day convinced the entrepreneurs that we are pro-market—not pro-businesses, [but] at least we were pro-market—that we were not old-fashioned socialists. (Eyzaguirre 2007, author’s interview)

Refraining from introducing major tax increases in the middle of a recession was a necessary, if not sufficient, for passing the economic governance test and reestablishing smooth working relations with the business sector.

Structural power had a second, indirect affect on the tax agenda as well: the context of recession made the more conservative Concertación legislators vulnerable to business and the right’s arguments that tax increases would hurt the economy. Not only would business and the right have balked at a major tax increase in 2000, but any such proposal probably would have been defeated with Christian Democratic votes as well. In fact, some Christian Democrats had joined with business and the right to call for tax *cuts* in 2000 as a way to stimulate economic recovery.<sup>5</sup>

### **Reform Design and Strategies for Managing Opposition**

Because of the issues discussed above, Lagos decided early on not to touch tax rates. Instead, the administration sought to raise the funds needed for social spending by fighting evasion and cutting down on tax avoidance, as elaborated in Lagos’ campaign platform.<sup>6</sup> This idea grew out of detailed studies conducted by the tax agency in 1999 as well as previous experiences with anti-evasion reforms in the 1990s. The Frei administration, for example, raised revenue for a pension increase in 1998 through an anti-evasion reform. However, the scope of the 2000 reform and the amount of revenue it sought to generate—an average of USD 680 million per year from 2002-2005—were unprecedented for an anti-evasion reform. The 1998 reform in comparison was intended to raise only around USD 100 million per year.<sup>7</sup> To my knowledge, the 2001 reform was the first major reform package in Latin America intended to raise significant funds for short-term and medium-term expenditures entirely by fighting tax evasion and tax avoidance, without creating new taxes or increasing tax rates.

The measures in the 2000 “Anti-Evasion” reform package can be grouped into two major categories: measures to fight tax evasion, and measures to broaden tax bases and/or close loopholes. Measures to fight evasion included more funding (USD 20 million per year) and more staff (539 additional auditors) for the tax agency, stronger sanctions and higher fines for breaking tax laws, and new powers to help the tax agency audit more effectively. Expanded access to bank information, which is crucial for detecting undeclared assets, would be among the tax agency’s new powers—the tax agency would be allowed to review bank information on loans and collateral. In addition, the time period for auditing VAT payments would be extended—the tax agency would be allowed to review records up to three years old rather than only two years old. These and other anti-evasion measures would generate about 84% of the total expected revenue from 2001-2005 in original proposal.

Measures to broaden tax bases and/or close loopholes primarily entailed establishing tighter restrictions on the use of, or in some cases eliminating, tax benefits that were technically unjustified and/or facilitated tax avoidance. Examples included restricting the use of tax losses in mergers, accelerated depreciation, and “presumed-income” tax regimes for small and medium businesses in agriculture and transport, as well as eliminating a tax credit that allowed business to deduct property tax

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<sup>5</sup>*El Mercurio*, Aug. 3, 2000: “Piden al Gobierno Bajar Impuestos a las Personas.”

<sup>6</sup>“La política tributaria deberá permitir cumplir con los compromisos sociales sin poner en riesgo el crecimiento y la estabilidad. Privilegiaremos la reducción de la evasión y la elusión, eliminando exenciones injustificadas y fortaleciendo la equidad de la estructura impositiva,” (Ricardo Lagos, “Para Crecer con Equidad,” October 1999:4).

<sup>7</sup>Informe de la Comisión de Hacienda, Cámara de Diputados, Boletín No 2.160-05: 7.

payments from the corporate income tax. Many of these reforms had been attempted during the 1990s without success. Figure 4.1.1 describes the most of important of these anti-avoidance measures, the problems they were designed to address, and the revenue they were expected to generate. Together, these measures would produce about 16% of the reform's total revenue yield from 2001-2005.

The design of the reform package offered several major political advantages. First, because the reform primarily entailed enforcing existing tax laws and did not involve rate increases, problems related to business's structural power would be curtailed. The Finance Ministry was certain that the reform would have no negative impact on investment (Eyzaguirre 2007, author's interview), and the reform design made business and the right's habitual arguments to the contrary less credible and hence less likely to create problems with conservative Christian Democrats.

Second, the design of the reform allowed the executive to make compelling legitimating appeals based on equity. The text of the reform proposal made a moral case for reducing evasion, which the government emphasized throughout the negotiation process:

FUNDAMENTOS:

1. Antecedentes sobre evasión de impuestos. ...
2. Imperativo ético. La evasión de impuestos representa una situación de gran inequidad entre quienes cumplen sus obligaciones tributarias y quienes no lo hacen. ...desde un punto de vista ético, nadie puede oponerse a una iniciativa que persigue el cumplimiento de la ley.<sup>8</sup>

The reform lent itself to appeals based on horizontal equity. Fighting evasion by definition improves horizontal equity, by ensuring that all taxpayers of similar economic means pay the taxes they owe. Emphasizing horizontal equity had the potential to build consensus with business by emphasizing shared interests; businesses that obey tax laws often support anti-evasion measure, because they view tax evasion as unfair competition. At the same time, emphasizing horizontal equity could help the government de-legitimize opposition and pressure legislators to pass the reform. The reform also facilitated vertical equity appeals, since it targeted large and medium-sized firms, as explained in the proposal text and confirmed by internal tax agency studies (Figure 4.1.2).<sup>9</sup> Lagos regularly stressed that evasion favored the rich at the expense of the poor at public events and in the press: "Yo decía: usted, cuando va a comprar un kilo de pan, usted está pagando 18% del IVA. Usted no tiene ningún trick, ningún mecanismo para pagar menos. Los pobres pagan todos sus impuestos. Y es justo que los ricos nos pagan todos sus impuestos," (Lagos 2007, author's interview).<sup>10</sup> The Finance Minister made similar appeals: "que los chilenos paguen los impuestos que deben pagar, como lo hace la inmensa mayoría, especialmente los mas modestos."<sup>11</sup> Vertical equity appeals aimed to pressure the right into accepting the reform. In fact, when debate on the anti-evasion reform continued into 2001, Lagos explicitly sought to make the reform an electoral issue in anticipation of the December parliamentary elections.<sup>12</sup>

The Lagos administration extended its moral case against evasion and its equity appeals to measures designed to control tax avoidance, as well as base-broadening measures that simply restricted unjustified tax benefits. This strategy was comprised of two components: first, equating tax avoidance with tax evasion in terms of moral impropriety, despite the fact that tax avoidance does not entail

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<sup>8</sup>Mensaje 178-342: "Proyecto de Ley que Establece Normas Legales para Combatir la Evasión Tributaria," August 24, 2000: 3.

<sup>9</sup>Ibid: 5.

<sup>10</sup>The former Tax Agency Director recalled these statements as well: "Ricardo Lagos every day was in the press saying everybody must pay taxes. If he was in a rally with poor people, he asked the lady, 'when you buy your bread you must pay your taxes, why don't other people want to pay their taxes?'" (Etcheberry 2005, author's interview). See also *El Mercurio*, March 14, 2001: "Lagos pidió apoyo al proyecto," and *El Mercurio*, Sept. 10, 2000: "Lagos recogió observaciones de empresarios."

<sup>11</sup>Eyzaguirre quoted in *El Mercurio*, March 10, 2001: "Crece respaldo."

<sup>12</sup>"En sus esfuerzos por lograr una acogida a la propuesta, el Presidente ha demandado de la ciudadanía castigo para los parlamentarios que voten en contra del proyecto." (*El Mercurio*, March 14, 2001: "Lagos recogió observaciones de empresarios"). The executive employed a similar strategy to align legislators from the governing coalition. See also *El Mercurio*, Jan 24, 2001: "Gobierno replantea su estrategia legislative."

breaking the law, and second, implicitly framing the use of legal tax benefits and exemptions as tax avoidance. A private sector observer described the first component of this strategy as follows:

El proyecto de ley... explicita, creo que por primera vez, de manera bastante clara, la intención de controlar la elusión, de controlar en el fondo la planificación agresiva... es yo creo lo que uno podría llamar una política lingüística intencional, en que se mezcla intencionalmente, se confunde lo que es elusión, planificación, evasión, inmoralidad... ha habido toda una política de confusión de lenguaje que de alguna manera legítima que se persigan figuras que son legales. (Tax Consultant A 2005, author's interview)

With regard to the second component of the strategy, the Finance Ministry anticipated that restricting tax benefits it judged technically unjustified would be highly controversial with business and the right. Framing these measures as controlling a morally unacceptable practice of tax avoidance rather than simply raising revenue by broadening tax bases could make it harder for the right to oppose the reform in congress. Executive branch officials in fact consistently denied that the reform imposed tax increases. For example, when asked by a reporter why the government had initiated a tax reform, the Finance Minister replied: “Discrepo de que sea una reforma tributaria. En lo fundamental hemos hecho una campana contra la evasión.”<sup>13</sup> The Secretary General of the Presidency adhered to the same line: “insistió que el proyecto sobre evasión tributaria ... no afecta los actuales niveles de la carga impositivo sino que únicamente apunta a impedir que mediante resquicios o ciertos mecanismos legales se evite pagar los impuestos que corresponde.”<sup>14</sup> The text of the reform proposal, likewise, characterized all of the measures that altered tax legislation as designed to “cerrar fuentes de evasión y elusión.”<sup>15</sup>

In addition to these tax-side legitimating strategies, the government employed benefit-side strategies. The tax reform was explicitly intended to fund Lagos' program of government, namely, expanded social spending, particularly in education, income support for the poor, and health care, as well as other initiatives. Lagos made this connection during his presidential campaign, and it was clearly expressed in the proposal text as well, which explicitly listed the social programs that the new funds would support.<sup>16</sup> However, links to social spending remained primarily discursive—reforms to expand spending were not included in the reform package, which dealt exclusively with tax measures. In contrast to most other Concertación tax reforms, which relied heavily on the strategy of linking to social spending and often included both tax and spending measures within a single reform package, linking to social spending was a secondary strategy in the 2001 reform, precisely because tax-side appeals to equity were so compelling. As Lagos (2007, author's interview) recalled: “En la reforma anti-evasión, más que el destino de los fondos—era para financiar mi programa, claro—pero...era más una discusión ética.”

### **Successes and Limitations of the Anti-Evasion Reform Design and Appeals to Equity**

The design of the 2001 reform and the combination of political strategies employed by the executive achieved a mixed record of successes and shortcomings. The emphasis on fighting evasion along with appeals to equity unquestionably helped make increasing tax revenue politically feasible and contributed significantly to the reform's eventual approval in congress. However, these strategies did not preclude major conflict with business or conflict within the governing coalition, and the executive had to negotiate extensive modifications with business leaders before the right allowed the reform to pass in congress.

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<sup>13</sup>*El Mercurio*, Oct. 8, 2000. Similarly, *El Mercurio* reported shortly after the proposal was sent to Congress: “Tanto el Presidente Ricardo Lagos como su Ministro de Hacienda Nicolás Eyzaguirre han subrayado que en coherencia con lo planteado durante la campana electoral pasada el Gobierno no está planteando un aumento de la carga tributaria sino que perfeccionando los mecanismos para reducir la evasión a fin de recaudar los recursos que resultan indispensables para financiar el ambicioso programa social comprometido.” (*El Mercurio*, Aug. 27, 2000). See also *El Mercurio*, August 26, 2000, and *El Mercurio*, Jan. 17, 2001.

<sup>14</sup>*El Mercurio*, Sept. 3, 2000: “Gobierno aspira a simplificar la tributacion.”

<sup>15</sup>Mensaje 178-342, Aug. 24, 2000: 4.

<sup>16</sup>Ricardo Lagos, “Para Crecer con Equidad,” Oct. 1999: 4; Mensaje 178-342, Aug. 24, 2000: 2, 6,-7.

On the positive side, the design of the reform and horizontal equity appeals achieved some modest success with respect to business and the right. First, the government clearly succeeded in establishing consensus with business on goal of fighting evasion. Business regularly expressed its unequivocal support for this goal in the press.<sup>17</sup> Second, business and the right did in fact support some of the anti-evasion measures, for example, stricter rules and higher fines for fabrication of fake VAT receipts. As the former Tax Agency director recalled:

There are people who are really maffias who sell bills to augment [VAT] credits, so that the enterprise pays less VAT. That is a criminal activity, its fraud. Well, in Congress it was rather easy to obtain more power to persecute and punish those people. Nobody wants to protect somebody who is [engaging in] fraud in Chile. (Etcheberry 2005, author's interview)

Third, framing base-broadening measures as fighting morally reprehensible tax avoidance put business on the defensive. Private sector informants confirmed that this strategy damaged business's public image (Tax Consultant A 2005, Mining Sector Tax Consultant 2005).<sup>18</sup> In order to justify its opposition to these measure, business found itself in the disadvantageous position of having to explain the subtle difference between evasion and avoidance to the general public, the vast majority of which had no experience with these practices.<sup>19</sup>

Evidence suggests that the reform design and appeals to equity did help the government maneuver the package through Congress. Concertación informants who participated in the negotiation process believed this to be the case. For example, the former president of the Senate asserted: "Yo creo en definitiva ellos mismos [the right] se convencieron que su argumento no tenía mucho fundamento... ¿La derecha estaba en una posición defensiva? Nada más, absolutamente defensiva... buscaban cualquier tipo de argumento," (Zaldívar 2007, author's interview).<sup>20</sup> Similarly, the former Tax Agency Director recalled: "The right asked the government to stop that, because they were associated with illegal things, being selfish, fraud. The right didn't want to be associated with fraud... So it was also a political battle. A political battle that I think we won." (Etcheberry 2005, author's interview). In fact, two right Senators explained to the press that they abstained instead of voting against the reform during its first hearing on the floor in anticipation of damaging government recriminations: "caso contrario, el Presidente Lagos hubiese dicho que la oposición se opone a que se combata la evasión tributaria."<sup>21</sup>

However, the reform design and associated legitimating strategies failed to preclude major opposition from business and the right. Despite support for some of the strictly anti-evasion measures, business and the right aggressively opposed key measures designed to help the tax agency enforce tax laws, in particular, granting the tax agency more powers. One of the most controversial (and in fact most important) such measures—granting the tax agency access to bank information on checking accounts—was left out of the original proposal precisely because it stimulated such virulent opposition

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<sup>17</sup>For example, the CPC's official statement on the reform asserted: "Resulta imprescindible dejar constancia que las organizaciones empresariales representadas en el Comité Ejecutivo de la CPC, han tenido y tienen una posición invariable en cuanto a rechazar la evasión tributaria, no sólo porque esta práctica constituye una competencia desleal e ilegítima a las actividades productivas y de servicios que cumplen con sus obligaciones, sino porque la práctica evasiva constituye un atentado ético repudiable," (CPC 2000).

<sup>18</sup>For example, one informant lamented the consequences as follows: "un discurso que ha sido dañino... en que las autoridades políticas se han referido a los grandes contribuyentes como evasores o elusores," (Tax Consultant A 2005).

<sup>19</sup>The following quote from RN Senator Romero highlights the point made above: "Aquí se habla de 'elusión,' un término que naturalmente no toda la población lo ha asimilado con suficiente precisión. Yo utilizo otra frase que es más adecuada... "descansos tributarios," y éstos son legales, legítimos." *Descanso tributario* is a term similar to "tax holiday." The Senator continued with creative imagery: "...Los "descansos tributarios" no son una evasión, sino que, reflejan la tranquilidad que tiene el contribuyente para suspender, en un momento determinado, una larga caminata para pagar impuestos en Tesorería, y sentarse en un sillón o en una banca en la plaza, frente a Teatinos." Teatinos is the street in front of the building that houses the Finance Ministry. *Diario de Sesiones del Senado, Legislatura 343a, Extraordinaria, Sesión 34a, April 4, 2001: 36.*

<sup>20</sup>Similarly, Boeninger (2005, author's interview) remarked that the reform's "basic legitimacy" helped secure right votes: "finally they had to concede that the reform was reasonable."

<sup>21</sup>Senators Pratt (RN) and Matthei (UDI), quoted in *El Mercurio*, March 15, 2001: "Avance tramite de evasión tributaria."

from business and the right.<sup>22</sup> Business also strongly objected to tax agency revision of bank information on loans and collateral, which was included in the reform package, arguing that it violated banking secrecy rules and taxpayers' privacy rights (CPC 2001a: 11). Business also complained about the government's plan to hire more tax auditors. The president of SOFOFA, the industry peak association, provocatively quipped in the press that in order to raise revenue, the administration had mused: "voy a contratar más inspectores de Impuestos Internos y voy a fregar a todos los empresarios de Chile."<sup>23</sup> The right followed suit, arguing that the tax agency was already too powerful and that taxpayers did not have sufficient rights and protections, given the absence of independent tax tribunals in Chile.<sup>24</sup> Direct appeals to business failed to build support on these issues. As the former Tax Agency Director recounted: "I am a friend of enterprise leaders, and I asked them: Why are you fighting this? You should be in favor. You don't evade taxes, its your competitors who do. ...Well, ...they want to have it both ways. ...They don't want their competition to avoid taxes, but they want to have that possibility," (Etcheberry 2005, author's interview). Meanwhile, the base-broadening measures proved as controversial as always, despite that fact that the government's tax-avoidance discourse put business on the defensive. In fact, portraying the use of the tax benefits in question as abusive and unfair antagonized business leaders, who resented the insinuation that they and their colleagues were engaging in illicit activities (Tax Consultant A 2005, author's interview). Business antagonism toward the government culminated in an infamous speech delivered by the president of the CPC at a prestigious annual business forum, the *Encuentro Nacional de Empresarios* (ENADE). Ariztía turned to Lagos, who was present with him on the stage in front of the large audience of businessmen, and declared, in clear allusion to the tax reform as well as the administration's proposed labor reform: "Señor Presidente, por favor déjenos trabajar tranquilos."<sup>25</sup>

Business and the right struck back against the base-broadening reforms in three ways. First, they called the government's bluff by pointing out that the bill did in fact contain tax increases. The CPC decried the reform as a "cambio profundo en las reglas del juego" that would increase the tax burden on those who already paid their fare share, rather than forcing evaders to obey the laws (CPC September 2000: 3), and the right denounced the proposal as a "reforma tributaria encubierta."<sup>26</sup> Second, business and the right asserted that the tax benefits the government sought to restrict or eliminate were critical investment incentives. For example, a CPC tax consultant who participated in negotiations with the government over the reform asserted that: "Cuando los proyectos se refieren a la elusión tributaria, están modificando normas que benefician a la inversión y solo porque el Gobierno ha estimado que se comete abuso. ...él que hace uso legítimo de las normas está en su pleno derecho..."<sup>27</sup> The president of the CPC stated this position in even stronger terms:

El proyecto de ley adquiere así un negativo sesgo anti-inversión al eliminar mecanismos que permiten moderar el impacto negativo que producen los impuestos sobre la inversión, e incrementando solapadamente la carga tributaria... Propuestas de este tipo resultan especialmente inconvenientes en momentos en que nuestra economía atraviesa por un lento y difícil proceso de recuperación económica.<sup>28</sup>

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<sup>22</sup>On business opposition to expanding access to bank information, see: CPC 2000: 6 and author's interviews: Ariztía 2005, CChC 2005, Etcheberry 2005, Aninat 2007, SII C 2007.

<sup>23</sup>*El Mercurio*, Oct. 6, 2000: "Lamarca: El país tiene un problema de gestión muy compleja,"

<sup>24</sup>See for example Deputies García (RN) and Espina (RN) in *Diario de Sesiones, Cámara de Diputados, Sesión 36, Legislatura 343*, Jan. 17, 2001: 66-67, 70; and Senators Prat (RN) and Novoa (UDI) in *Diario de Sesiones del Senado, Legislatura 343, Sesión 34*, April 4, 2001: 54, 57.

<sup>25</sup>*El Mercurio*, Nov. 22, 2001. Ariztía (2005, author's interview) recalled later: "se lo dije en la cara ahí, la sala se vino debajo a aplausos... A qué estaba asociado eso: veníamos de una batalla enorme por el tema tributario y laboral."

<sup>26</sup>See for example: *El Mercurio*, Aug. 27, 2000: "Es difícil que ley trib salga este año," *El Mercurio*, Aug. 6, 2000: "Lamarca: El país tiene un prob de gestion muy compleja."

<sup>27</sup>Brzvoic, quoted in *El Mercurio*, Dec. 20, 2000.

<sup>28</sup>Ariztía interviewed in *La Tercera*, Jan 20, 2001: "Orientaciones para un sistema ideal."

The right reiterated the same points. Third, business and the right endeavored to counter the executive's appeals to vertical equity by claiming that the reform would hurt small and medium businesses.<sup>29</sup> Arguing that the reform would hurt small enterprises and hinder economic recovery was part of a broader strategy to strip the Concertación of support from small business and to draw more conservative Christian Democratic legislators away from the government's fold (Silva 2002: 351).

In fact, business's counter-offensive did resonate with the conservative wing of the PDC. The Finance Minister recalled: "The tax evasion law was very hard to work, especially with the Christian Democrats, because the arguments that this was detrimental for small business and the middle class did penetrate them somewhat," (Eyzaguirre 2007, author's interview). Problems with the PDC contributed to delays in sending the proposal to congress in fall of 2000. A number of PDC senators urged the executive to hold off on the reform until the economy showed concrete signs of recovery.<sup>30</sup> PDC dissent also compelled the executive to remove several measures from the original drafts of the reform before it was sent to Congress, including restrictions on the presumed income regime for agriculture.<sup>31</sup> Many Christian Democrats objected to the restrictions because they were seen as hurting small producers who were already hard hit by the economic recession, despite the fact that tax agency studies showed that presumed income regimes primarily benefited large producers.<sup>32</sup> Ultimately, restrictions on the presumed income regime for transport, which were included in the bill, were defeated on the Senate floor with Christian Democratic votes. In addition, several Christian Democrats were reluctant to grant the tax agency additional powers, which business and the right also argued would hurt small and medium businesses.<sup>33</sup> PDC opposition, along with business and right opposition, contributed to the executive's decision not to include access to checking accounts in the reform proposal among the new powers requested for the tax agency (Zaldívar 2007, author's interview). The executive also had to make several concessions regarding tax agency access to information on loans and collateral.<sup>34</sup> In the end this measure passed in the Senate amidst significant controversy regarding the voting procedure and over the strident objections of several Christian Democrats, along with the right.<sup>35</sup>

Not only did legitimating appeals fail to neutralize business opposition and prevent disciplinary breaches within the Concertación, but efforts to mobilize popular opinion in favor of reform did not induce the right to break ranks with business. The bill passed in the House of Deputies thanks to the Concertación's majority; the right voted against the reform in block.<sup>36</sup> And the right held up the reform in the Senate, where the Concertación and the Alianza were essentially tied, until the executive negotiated major concessions to the base-broadening and other measures that placated business (see Figures 4.1.4

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<sup>29</sup>See for example: CPC 2000; *El Mercurio*, Dec. 13, 2000: "El test del proyecto de evasión;" *El Mercurio*, Sept. 19, 2000: "No es el momento para discutir evasión tributaria;" and Senator Pratt (UDI) quoted in *El Mercurio*, April 15, 2001: "Reforma Tributaria."

<sup>30</sup>*El Mercurio*, Aug. 12, 2000: "Violación de Secreto Bancario Preocupa a los Senadores DC," *El Mercurio* Aug. 28, 2000.

<sup>31</sup>*El Mercurio*, Aug. 15, 2000: "Analiza acotar proyecto contra la evasión;" *El Mercurio*, Aug. 17, 2000: "Llegan a acuerdo en evasión tributaria."

<sup>32</sup>The tax agency found that contributors in the presumed income regime for agriculture paid on average two and a half times less than they would under the normal income tax regime. However, paradoxically, and contrary to the purpose of the presumed income tax regime, large producers benefited most, whereas small producers actually paid more than they would have under the normal income tax regime (SII 2000b: 17-18).

<sup>33</sup>*La Segunda*, Nov. 14, 2000: "Brzovic: Proyecto de evasión desincentivara la inversion."

<sup>34</sup>In this case, the concessions did not interfere much with the purpose of the reform (Jorratt 2005, author's interview).

<sup>35</sup>Diario de Sesiones del Senado, Legislatura 343, Extraordinaria, Session 46, May 16, 2001: 29-60. Not all Christian Democrats opposed greater powers for the tax agency. A contingent of PDC deputies in fact agitated for the executive to reintroduce even stronger measures to give the tax agency bank information that had been removed from the original drafts of the reform before it was sent to Congress (*El Mercurio*, Aug. 28, 2000; "Es difícil que ley tributaria salga este año," *El Mercurio*, Aug 27, 2000).

<sup>36</sup>Diario de Sesiones, Cámara de Diputados, Sesión 36, Legislatura 343, January 17, 2001, Diario de Sesiones, Cámara de Diputados, Sesión 33, Legislatura 343, January 10, 2001. Senator Boeninger explained the government's disappointment with the results in the House of Deputies: "Ese rechazo fue gatillado por los empresarios y reflejado en la actitud de los parlamentarios. Creo que la molestia que en ese momento expreso el Ministro Eyzaguirre se explica porque él hizo un esfuerzo muy grande al enviar un conjunto de indicaciones al proyecto original para resolver varias de las observaciones que le habían llegado desde el mundo empresarios. Y el lamento que a pesar de esos esfuerzos, la oposición votara en contra," (*El Mercurio*, Jan. 26, 2001: "Rebaja, que se impone.")



and 4.1.5). While business did not embrace the final version of the reform, informants agreed that it was much more acceptable than the executive's original proposal (author's interviews: Ariztía 2005, CChC 2005, Urenda 2005, SOFOFA 2005, Mining Sector Tax Consultant A 2005).<sup>37</sup>

Passing the 2001 reform proved a lengthy and difficult process. Government informants as well as business informants remembered the anti-evasion reform as one of the most difficult and controversial tax reforms of Lagos's term. According to Lagos (author's interview 2006): "faltó mucho sacar eso. fue muy difícil;" Eyzaguirre (author's interview 2007) asserted that the reform entailed "a major spending of political capital." Conflict with business and the right, occasional difficulties with the PDC, and the complicated reform design—a tradeoff associated with the anti-evasion strategy, which required a large and complicated reform package—kept the reform in Congress for almost a year. The government sent the bill in August of 2000 and hoped to have it approved by the end of the year.<sup>38</sup> However, the reform did not become law until mid-June of 2001, ten months after the executive sent the proposal to Congress.

Nevertheless, in final analysis, the importance of the anti-evasion reform design and associated legitimating appeals should not be underestimated. Given the strong constraints that Lagos faced during the first years of his term, managing to pass the reform was a significant accomplishment. And in fact, we will see that the reform was a major success in terms of revenue capacity.

### **The Outcome: A Revenue-Raising Success**

In the Chilean context, the 2001 reform was a definitive revenue-raising success. In absolute terms, the reform generated a major portion of the funds Lagos needed to finance his social programs. The final version of the legislation approved by Congress was expected to generate USD 774 million per year from 2005 on (many measures in the reform by design were phased in gradually over the first four years), and a total of USD 2,588 million over the course of Lagos's term (2001-2005). In fact, the reform's actual revenue yield significantly exceeded these expectations, possibly by as much as 50% (author's interviews: Etcheberry 2005, SII A 2005, Marcel 2005, Lagos 2006).<sup>39</sup> In comparative terms, the 2001 reform, with an annual yield of roughly 1% GDP, was the most important revenue-raising tax reform legislated since the 1990 reform, which had increased annual revenue by about 2% GDP.

The government was relatively successful in terms of minimizing revenue loss during the negotiation process after the proposal had been sent to Congress, despite the fact that significant concessions had to be granted to business and the right (Figure 4.1.3). Relative to the expected yield of the original bill, revenue loss was marginal: 7% per year for 2005 on, and a total of 13% for 2001-2005. In absolute terms, the revenue loss was non-trivial, but still moderate. The final legislation approved by Congress was expected raise USD 61 million less than the original version per year for 2005 on, and a total of USD 402 million less over the course of Lagos' term. While USD 402 million was a large amount of money, that loss was equal to only one year's worth of revenue from the one-point VAT increase legislated in 2003—it was not very significant in comparative terms. The bulk of the total revenue loss after the bill was sent to Congress can be attributed to the long negotiation process. The fact that the reform did not become law until mid-2001, instead of January 2001, accounted for about 52% of the total revenue loss over Lagos' term (2001-2005). Meanwhile, a large portion of the yearly revenue loss was associated with changes to the controversial base-broadening reforms. Concessions to business and the right on these measures accounted for almost half (47%) of the annual loss for 2005 on, and over a third (34%) of the total loss from 2001-2005. Figure 4.1.4 describes these concessions and their associated revenue cost.

Compared to the executive's original revenue target for the anti-evasion reform—USD 1000 million per year (Etcheberry 2005, author's interview)—revenue loss was more significant, but still

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<sup>37</sup>Informants from the right parties agreed with this assessment: "después de todo lo que pudo haber sido, yo creo que fue bastante menos malo de lo esperado," (Alvarez 2005, author's interview).

<sup>38</sup>*El Mercurio*, Sept. 27, 2000: "Reformas laborales y proyecto contra la evasión."

<sup>39</sup>Official estimates for actual revenue increases could not be obtained; it is difficult to make estimates from aggregate tax statistics since a number of other reforms were legislated during the 2001-2005 period.

comparatively moderate: 23% (USD 226 million per year) (Figure 4.1.3). Most of that overall revenue loss occurred during the design phase. The proposal sent to Congress fell about USD 164 million short of the administration's initial goal, a relative loss of 16%. These figures help to illustrate two common features of tax politics in Chile: Concertación administrations tend to ask only for what they think is feasible based on their anticipations regarding the reactions of business and the right, and therefore the most significant business influence occurs at the agenda formulation and reform design stages.

Given the statistics presented above, it is not surprising that Concertación leaders were quite happy with the outcome of the reform. Essentially all government officials and governing coalition legislators interviewed for this project expressed their satisfaction with the reform and the revenue it generated,<sup>40</sup> as well as the conviction that the Concertación obtained the best possible deal given the constraints it faced. In addition, the conflict the reform created with business proved transitory. Government-business relations improved significantly after 2003, in part because Lagos had pursued his most controversial reforms during his first years in office (Ariztía 2005, author's interview), and in part because a new generation of business leaders who preferred to avoid open confrontation with the government subsequently assumed leadership of key business associations including the CPC and SOFOFA (author's interviews: Etcheberry 2005, Eyzaguirre 2007).

### **Pending Tax Issues**

From the point of view of the Concertación's broader tax agenda, the anti-evasion reform represented an incremental advance, notwithstanding its revenue-raising accomplishments. Many of the measures included in the original reform proposal fell short of what the tax agency actually wanted, and a number of important measures were entirely excluded from the proposal, because the executive concluded that, like increasing the corporate tax (Chapter 3), they were politically infeasible (Figure 4.1.5). For example, the tax agency initially sought to restrict the use of accumulated tax losses to a period of three to five years (SII A 2005, author's interview)—unlike most countries, Chile allows infinite carry-forward and carry-back of losses—but the reform bill placed no limits on the use of losses beyond the special case of mergers. Access to checking accounts, which is perhaps the single most important measure for fighting tax evasion among upper-income groups in Chile (Jorratt 2005), was among the tax agency's requests that were left out of the original reform proposal because of intense opposition from business and the right, as well as resistance from within the PDC. Expanding tax agency access to bank information remains a pending, and politically problematic, issue for the future (see Chapter 6, Part 1).

Subsequent parts of this chapter will address several other issues identified as problems by Concertación tax experts that were inadequately or simply not addressed in the 2001 reform, primarily due to anticipated problems arising from business's instrumental power. Part 3 examines subsequent efforts to deal with under-taxation in the mining sector, which was only partially addressed by the measures in the 2001 reform, involving sub-capitalization, accelerated depreciation, and the presumed income regime. Part 4 analyzes the Lagos administration's eventual success in eliminating a highly regressive tax benefit for stock-owners, a measure that was excluded from the 2001 reform as politically infeasible. And Part 5 examines subsequent efforts to restrict the use of a VAT benefit for the construction of homes, a major revenue-raising and equity-improving reform which the tax agency also recommended addressing in 2000 (SII 2000a: 14, 28).

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<sup>40</sup>The reform in fact produced more revenue than anticipated.

**Figure 4.1.1: Selected Measures to Control Tax Avoidance, Anti-Evasion Reform Bill**

Sources: Ministerio de Hacienda, Dirección de Presupuestos: Informe Financiero N.21, August 2000; Mensaje de Proyecto 178-342, August 24, 2000; Author's Interviews (Jorratt 2005, SII A 2005, SII B 2005)

Measure	Problem Targeted	Description of Modification	Total Revenue, 2001-2005 (million USD)
<b>Eliminating credit for property tax against corporate income tax</b>	<b>Technically unjustified tax benefit.</b>	Permanently eliminates the tax credit, which had been temporarily suspended in 1998.	216.6
<b>Restricting use of accelerated depreciation</b>	<b>Technically unjustified tax benefit:</b> Accelerated depreciation allowed firms to defer corporate taxes on their profits, and allowed shareholders of partnerships (sociedades de personas) to defer individual income taxes on distributed profits. Consequently, shareholders could withdraw profits that had not paid any corporate taxes, without paying individual income taxes either. Significant problem in mining sector.	Accelerated depreciation can be used for corporate income taxes only. Distributed profits pay income taxes without accelerated depreciation, regardless of firm type.	90.3
<b>Eliminating VAT exemption for sale of firms' fixed assets</b>	<b>Technically unjustified tax exemption:</b> Fixed assets entered the VAT base only if they were sold within a year of purchase.  <b>Tax avoidance:</b> Allows individuals to avoid the VAT by purchasing assets like vehicles through corporations.	Fixed asset sales to pay VAT regardless of how much time passed since the original purchase.	60.6
<b>Sub-capitalization rule</b>	<b>Tax avoidance:</b> Firms repatriated profits to foreign owners in the form of interest payments on loans, which paid a tax rate of 4%, instead of profits, which paid a withholding tax of 35%. Significant problem in mining sector.	Interest payments to be treated as repatriated profits when the firm's debt to equity ratio exceeds 3 to 1.	35.4
<b>Restricting presumed income regimes for mining and passenger transportation</b>	<b>Tax avoidance:</b> Large firms could subdivide in order to pay lower taxes under presumed income regimes.  <b>Unjustified Violation of Horizontal Equity:</b> Presumed income tax regimes allowed some firms to pay lower taxes than others with similar profits, purely because they engaged in a particular type of economic activity.	Low the maximum yearly sales limits for transportation to USD 0.6 million per year.	20.1
		Low the maximum yearly sales limits for mining to USD 1.2 million per year.	3.3
<b>Restricting use of tax losses in mergers</b>	<b>Tax avoidance:</b> Companies would buy bankrupt firms—in some cases simply accounting books of firms that had long since ceased to operate—for the sole purpose of deducting those losses from their tax obligations.	Previously generated tax losses cannot be used when the acquired firm engaged in a different realm of economic activity.	12.2

**Figure 4.1.2: Incidence of Selected Measures in the Anti-Evasion Reform Bill**  
Sources: Internal Tax Agency and Finance Ministry Reports, Santiago, Chile, 2000.

Selected Reform Components		Taxpayers most Affected		
		Large†	Medium††	Small*
Anti-Evasion Measures	Greater access to bank information	√	√	
	Extend period for auditing VAT payments	√	√	√
	More Auditors	√	√	√
	Higher sanctions	√	√	√
Base-Broadening and/or Loophole-Closing Measures	Eliminating credit for property tax against corporate income tax.	√ (Firms)	√ (Firms)	
	Restricting use of tax losses in mergers.	√ (Firms)		
	Restricting use of accelerated depreciation.	√ (Shareholders)	√ (Shareholders)	
	Sub-capitalization rule	√ Firms		
	Restricting presumed income regimes for mining and transportation	√	√	
	Eliminating VAT exemption for sale of firms' fixed assets	√ (Firms)	√ (Firms)	

† Yearly sales over 50,000 UF (roughly USD 1.4 million); Individuals in top two tax brackets.

†† Yearly sales below 50,000 UF but over 25,000 UF (roughly USD 0.7-1.4 million); Individuals in three middle tax brackets.

\* Yearly sales under 25,000 UF (roughly USD 0.7 million); Individuals paying no income tax or in lowest bracket

**Figure 4.1.3: Revenue Estimates (Million 2000 USD), Anti-Evasion Reform**

Sources: Author's calculations based on Ministerio de Hacienda, Dirección de Presupuestos: Informe Financiero N.21, August 2000 and Informe Financiero N. 6, May 2001; Diario de Sesiones del Senado, Legislatura 343, Extraordinaria, Sesión 45, May 15, 2001; Cámara de Diputados, Oficio 3339, May 16, 2001.

	Legislation Approved by Congress	Revenue Loss Compared to:			
		Bill Sent to Congress		Original Revenue Target	
		Percent	Absolute	Percent	Absolute
<b>Per Year, 2005 On</b>	774	7%	61	23%	164
<b>Total, 2001-2005</b>	2,588	13%	402	NA	NA

**Figure 4.1.4: Fiscal Cost of Concessions  
on Base-Broadening and/or Loophole-Closing Measures**

Sources: Author's calculations based on Ministerio de Hacienda, Dirección de Presupuestos: Informe Financiero N.21, August 2000 and Informe Financiero N. 6, May 2001; Diario de Sesiones del Senado, Legislatura 343, Extraordinaria, Sesión 45, May 15, 2001; Cámara de Diputados, Oficio 3339, May 16, 2001.

**Percent of total revenue loss (2001-2005) from concessions on the measures below: 34%**

**Percent of total revenue (2001-2005) expected from final legislation arising from measures below: 12%**

	<b>Final Revenue Estimate, 2001-2005 (million 2000 USD)</b>	<b>Percent Revenue Loss Compared to Original Measure</b>	<b>Concession Granted</b>
<b>TOTAL</b>	<b>302.2</b>	<b>31%</b>	
Eliminating credit for property tax against corporate income tax	200.6	7%	Exemption for construction sector: new but unsold buildings retain the credit.
Restricting use of losses	11.3	8%	No changes (revenue loss corresponds to 2001).
Accelerated depreciation for corporate tax only	60.2	33%	No changes (revenue loss corresponds to 2001).
Sub-capitalization rule	3.9	89%	Various concessions to soften the impact, including phase-ins.
Restricting presumed income regime for mining	2.5	25%	Does not take affect until 2003.
Restricting presumed income regime for transport	0	100%	Rejected in congress.
Eliminating VAT exemption for sale of fixed assets	23.7	61%	Assets sold four years or more after purchase remain exempt.

**Figure 4.1.5: Comprises and Concessions Made By Finance Ministry  
In Designing the Anti-Evasion Bill and Negotiating Approval in Congress**

Sources: Servicio de Impuestos Internos: “Propuesta de Reforma al Impuesto a la Renta,” “Plan de Lucha Contra la Evasión,” “Propuesta de Reforma en los Impuestos Indirectos,” Santiago, March 2000; Internal Tax Agency and Finance Ministry Reports, Santiago, 1999, 2000; Interviews (Jorratt, Rojas, Lara); Mensaje de Proyecto 178-342, August 24, 2000; Diario de Sesiones del Senado, Legislatura 343, Extraordinaria, Sesión 45, May 15, 2001; Cámara de Diputados, Oficio 3339, May 16, 2001

Issue		Tax Agency Proposal To Finance Ministry	Bill Sent by Finance Ministry to Congress	Final Legislation Approved by Congress
<b>Powers for Tax Agency</b>	Bank information access	Access to corporate checking accounts.	<b>Not Included.</b>	
		Access to bank information more broadly.	<b>Compromise:</b> Access to information on credit operations and guarantees.	<b>Concessions:</b> No access to personal credit cards, no access to records over three years old.
	Time limits for auditing	Eliminate proscription period for investigating VAT records.	<b>Compromise:</b> Extend investigation period from 2 years to 3 years into the past.	Same as original bill.
<b>Broadening Income Tax Base</b>	Credit for property tax against corporate income tax.	Eliminate the tax credit.	Same as Tax Agency proposal.	<b>Concession:</b> Exemption for construction sector: new but unsold buildings retain credit.
	Carry-forward and carry-back of losses	Restrict period allowed for carry forward to between 3 and 5 years; eliminate carry-back.	<b>Compromise:</b> Restricting use of previously generated losses in mergers, no limits imposed more generally.	Same as original bill.
	Accelerated depreciation	Restrict use of accelerated depreciation to the corporate tax only.	Same as Tax Agency proposal.	Same as original bill.
	Sub-capitalization	Interest payments abroad to be treated as repatriated profits when the debt to equity ratio exceeds 2 to 1.	<b>Compromise:</b> Debt to equity ratio increased to 3 to 1.	<b>Concessions:</b> Various concessions to soften the impact, including phase-ins.
	Presumed income regimes	Eliminate presumed income regime for mining.	<b>Compromise:</b> Reduce maximum sales limit from 600 UTM to 167 UTM (~USD 1.2 million per year).	<b>Concession:</b> Would not take affect until 2003.
		Reduce maximum sales limit for transport to 1000 UTM.	<b>Compromise:</b> Reduce maximum sales limit to 1,200 UTM (~USD 0.6 million per year).	<b>Rejected</b> in congress.
		Reduce maximum sales limit for agriculture to 1000 UTM.	<b>Not included.</b>	
<b>Broadening VAT Base</b>	Exemption for sale of firms' fixed assets	Eliminate the exemption.	Same as Tax Agency proposal.	<b>Concession:</b> Assets sold four years or more after purchase remain exempt.

## **Part 2. The 2003 VAT Increase in Comparative Perspective: Linking Taxes that Lack Inherent Legitimacy to Spending**

When a tax lacks inherent legitimacy, linking to popular spending programs can be an especially important reform strategy. On various occasions, Concertación administrations were forced to resort to regressive taxes because generating revenue with more progressive tax instruments was politically infeasible due to business's strong instrumental power. Such was the case in 2003, when the Lagos administration needed additional revenue to fund social spending in the context of free-trade treaties that entailed tariff reductions.

This section examines the reform process and evaluates the use of linking to social spending and emphasizing fiscal discipline in the case of the 2003 VAT increase, as well as a 2006 reform that made the temporary VAT increase permanent. To provide additional comparative perspective, two reforms from the Frei administration that linked indirect taxes to popular spending programs are considered as well.

Examining these four reforms provides insights into the conditions under which linking to spending tends to be more or less successful. Two factors make for an optimal strategy design: first, a strong linkage technique (either contingency on approval of tax increases or inclusion of spending programs and financing measures in the same reform package), and second, associated social programs that provide clear and timely benefits.

In all of the cases examined here, linking to spending facilitated the tax increase in question. Linking to spending helped the executive maintain internal discipline with respect to each reform, although levels of discontent within the Concertación over the executive's choice of a regressive tax instrument varied across the cases. And executive policymakers viewed linking to spending as necessary for managing opposition to taxation from the right. However, even an optimally-designed linking strategy could fail to win opposition votes and/or minimize debate over tax increases. In some cases, opposing the tax increase was politically advantageous for the right, notwithstanding pressures associated with linking to spending. For example, opposition from the right on several occasions aimed to exacerbate discontent within the Concertación over regressive taxation and thereby to weaken the government.

### **The 2003 VAT Increase**

The 2003 VAT increase demonstrates the tradeoffs the executive branch has had to juggle in order to raise revenue. Resorting to a regressive tax instrument secured complacency from business but provoked discontent within the Concertación and thus created a political opportunity for the right to attack the coherence of the administration's policy choices and to exacerbate conflicts within the governing coalition. Linking to spending and emphasizing fiscal discipline were critical for securing the minimal number of votes needed to pass the reform, but these strategies did not win any UDI or RN votes. Strategic errors on the part of the executive, namely, weak links to spending and associated benefits that were neither clear nor immediate, helped create space for the right to reject the reform. While the executive received all but 10% of the revenue it had requested, the VAT increase only partially compensated revenue loss to tariff reductions, and the social programs in question had to be funded through reallocation of existing resources (author's interviews: Marcel 2006, Finance Ministry B 2005).

### ***Revenue Needs and Limited Funding Options***

Despite the success of the anti-evasion reform, passed two years earlier, the Lagos administration found itself in need of additional revenue in 2003. Major trade treaties had recently been signed with the US and the EU, which entailed a significant loss of revenue from tariff reductions. The Finance Ministry estimated the cost at 430 million dollars per year (0.7% GDP).<sup>1</sup> Meanwhile, the administration was

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<sup>1</sup>Mensaje de S.E. el Presidente de la República que establece el financiamiento necesario para asegurar los objetivos sociales prioritarios del Gobierno, Boletín 3256-05, June 11, 2003: 3.

designing a major health care reform, *Plan AUGE*, and one of the primary proposed financing mechanisms, which involved redistributing to the public sector 3/7 of payroll tax contributions made to the private health care system (ISAPRES), had been blocked in Congress.<sup>2</sup> Although this funding proposal had passed in the lower house, Christian Democrats opposed the measure along with the right in the Senate. The PDC maintained that this redistributive mechanism would hurt the middle class.<sup>3</sup>

To compensate revenue loss from the free trade treaties and to fund expanded social spending, the Lagos administration proposed increasing the VAT from 18% to 19%, as well as increasing excise taxes on alcohol and tobacco. The bulk of the expected revenue (90% of the total to be generated from 2003-2006) would come from the VAT increase.

Direct tax increases at this time remained off the agenda. The administration had expended substantial political capital passing the Anti-Evasion reform (Part 1), and the corporate tax had been increased by two points the previous year with major opposition from business and the right (Chapter 3). In this context, Lagos (2006, author's interview) felt he had no alternative but to select the tax instrument least objectionable to business and the right: "no tenía ninguna otra posibilidad de aumentar ningún otro impuesto. Porque iba a ser rechazado. ...Entonces lo único que yo pude hacer fue ... esto, aumentando el IVA." Similarly, Eyzaguirre (2007, author's interview) asserted: "at the end of the day if you want to have *some space*, it is easier through the indirect taxes, with the right wing."

### ***Linking to Spending and Emphasizing Fiscal Discipline***

To manage opposition to the tax increases, the administration leveraged two related benefit-side strategies: emphasizing fiscal discipline, and linking to social spending. The proposal text made explicit that the tax increases were necessary to maintain fiscal discipline without jeopardizing funding for reforms that had already been approved;<sup>4</sup> the free trade treaty with the US had been under negotiation for some time, but the process was completed much sooner than the administration expected (Finance Ministry B 2005, author's interview). The proposal text also pointed out that the health care reform, *Plan Auge*, and a new targeted social spending program, *Chile Solidario*, still did not have permanent funding sources, despite the fact that these reforms were advancing in Congress.<sup>5</sup> While the VAT and excise taxes on their own were regressive and therefore did not enjoy inherent legitimacy, linking to spending made the net impact of the reform progressive and therefore helped to legitimate the tax increases. The Finance Ministry asserted that families in the bottom 20% would receive more than half of the net benefits associated with the free trade treaties, the spending programs, and the tax increases that would fund them, while the poorest 40% would receive two thirds of the benefits.<sup>6</sup>

The executive employed two secondary tax-side strategies as well: equity appeals and attenuating impact. Despite the fact that the VAT and excise taxes were regressive, the executive attempted to justify the tax increases on the basis of vertical equity. Poor people tend to pay a larger fraction of their income in sales taxes than the rich, but the majority of funds from the VAT and excises nonetheless originate from upper-income groups. The Finance Ministry estimated that 48% of the new funds from the VAT increase and the excise taxes would come from the top 20% of the population.<sup>7</sup> In addition, the administration attenuated the impact of the VAT increase by making it temporary. According to the reform proposal, the VAT rate would revert to 18% in 2007.

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<sup>2</sup>See Tokman et al. 2005 and Boeninger 2005: 25.

<sup>3</sup>Senator Boeninger (2005, author's interview), a member of the PDC's Consejo Económico Social, asserted: "more than 80% of the people who paid those contributions were middle class employees, and the majority of them had monthly salaries of 600,000 pesos or less, and therefore it was not reasonable to approve a policy that would redistribute the [burden] of financing health [to] the rather modest middle class... That was unacceptable to us." Boeninger (2005: 25) asserts that 80% of the contributors had salaries of 800,000 pesos or less. These "middle-class" sectors constituted a "natural enclave of support" for the PDC, and the party adopted an official position of opposition to the redistributive funding mechanism (Ibid.).

<sup>4</sup>Mensaje, Boletín 3256-05, June 11, 2003: 1- 4.

<sup>5</sup>Ibid.: 1.

<sup>6</sup>Ibid.: 5.

<sup>7</sup>Ibid.: 6; See also *La Segunda*, May 22, 1995 and *El Mercurio*, May 29, 1995 for tax-side vertical-equity legitimating appeals.



### ***Minimal Conflict with Business at the Cost of Concertación Discontent and Right Attacks***

The combination of reform strategies employed successfully neutralized business opposition. However, this success came at the cost of significant discontent within the Concertación regarding the use of a regressive tax instrument. Moreover, the reform design created a political opportunity for the right to attack the government, and the executive secured barely enough votes to pass the VAT increase.

Although business did not like the VAT increase (CPC 2003, Urenda 2007, author's interview), in practice, business associations did not oppose the reform (author's interviews: Eyzaguirre 2007, Beyer 2007, Marcel 2006). The executive's emphasis on fiscal discipline was well-received by business leaders who viewed the free trade treaties as highly desirable (author's interviews: Beyer 2007, Aritía 2005). As the former president of the CPC recalled:

...hubo una explicación del Director del Presupuesto convincente. Como consecuencia de la negociación de los tratados bilaterales con los distintos países, iba a haber un menor ingreso, y ese menor ingreso había que compensarlo. Nosotros íbamos a tener un beneficio, y a cambio de eso aumentaba el IVA. (Aritía 2005, author's interview).

Given the need to compensate revenue loss from the free trade treaties, business recognized that a VAT increase was the least objectionable choice of tax instruments. The VAT does not directly affect business; the majority of the cost is usually passed on to consumers. And the VAT, which is efficient and non-distortionary, is the tax that is most compatible with the orthodox economic views championed by the business sector. Moreover, business understood that the logical alternative to the VAT would have been a corporate income tax increase, and business sought to avoid that possibility above all else (author's interviews: ABIF 2005, Beyer 2007). Certain sectors within the Concertación had in fact proposed increasing the corporate tax instead.<sup>8</sup> An informant from the *Centro de Estudios Públicos*, a think tank with close ties to business, explained: "En este contexto, las medidas eran o el IVA o el impuesto a las empresas. Parecía mejor el IVA que el impuesto a las empresas. Entonces eso fue lo que no generó una gran oposición del mundo empresarial," (Beyer 2007, author's interview). In addition, the CPC's former General Manager asserted that linking to social spending made it difficult to oppose the reform: "como este IVA era para financiar el AUGE y el Chile Solidario, era mas difícil oponerse. Porque la gente decía ah, se está oponiendo a mejorar la salud... Por este mismo razón, el gobierno lo planteó así. Para que oponerse al alza de impuesto fuera en el fondo oponerse a mejorar la salud," (Urenda 2007, author's interview).

However, placating business entailed a tradeoff, namely, stimulating discontent within the Concertación. The Socialists and a number of Christian Democrats objected to the VAT increase based on equity considerations, notwithstanding the links to progressive social spending. As Lagos (2007, author's interview) recalled:

De un punto de vista de justicia tributaria, aumentar el IVA is rather unfair for the poor people. ...Entonces, eso fue un gran discusión con la propia Concertación, porque la Concertación no quería aumentar el IVA. Quería el impuesto a las personas, o el impuesto primera categoría a las empresas.

The executive requested only a temporary VAT increase partly to mitigate opposition from within the coalition.<sup>9</sup> In addition, to secure the Socialists' votes, the Finance Ministry agreed to provide a small one-time subsidy payment to low income families to compensate for the impact of the tax increases on transportation prices (author's interviews: Marcel 2006, Lagos 2006, Gazmuri 2005). The Finance Ministry also agreed to study the possibility of a royalty on copper extraction, an idea that had been

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<sup>8</sup>A number of legislators called attention to Chile's low corporate tax rate while the VAT increase was being debated in Congress. See Avila, Lavandero, and Ominami in *Diario de Sesiones del Senado, Legislatura 349, Ordinaria, Sesión 9, July 8, 2003: 58, 60-63, 79*. See also *La Nación*, June 11, 2003: "Haciendo no acoge demanda DC y presenta impuestos específicos" on PDC suggestions that the corporate tax serve as an alternative to the VAT increase.

<sup>9</sup>Marcel (2006, author's interview) observed that the Finance Ministry would have proposed that the VAT increase be permanent if it were not for opposition from the legislators.

gaining support within the Concertación more broadly over the past three years (author interviews: Tokman 2005, Marcel 2006) (see Chapter 4, Part 3).

While the executive did manage to maintain internal discipline, so-doing was not a trivial matter, as Lagos (2006, author's interview) recalled:

Algunos diputados y senadores socialistas criticaron mucho el aumento del IVA. Allí yo tuve que actuar en el teléfono... Uno me dijo, 'puedo yo decir en el parlamento que voy a votar sí porque usted me llamó por teléfono, sólo porque lo respecto?' Yo dije sí, puede decirlo. El Presidente está preocupado por esto.

In fact, six of the 14 Concertación legislators who spoke during the debate in the senate openly complained that the VAT was regressive and that the government should have pursued other alternatives, including a copper royalty or progressive direct taxes.<sup>10</sup> One of the strongest objections came from PDC Senator Moreno, who declared: “¡Estamos forzados a votar un impuesto antipático! ¡Es antipático e ingrato lo que estamos haciendo!”<sup>11</sup> Moreno nonetheless voted in favor of the reform, along with the rest of the Concertación Senators.

Meanwhile, linking to spending did not secure right party votes and proved relatively unsuccessful at containing debate over taxation. The UDI and the RN voted against the tax increases in the Senate unanimously and with perfect attendance. The VAT increase passed 25 to 22 thanks to favorable votes from two of the three designated senators who tended to be less conservative on social and economic policy (Vega and Zurita). However, all designated senators who were not Concertación appointees voted against the excise tax increases, which were rejected by slim margins.<sup>12</sup>

The Alianza's rejection of the VAT increase may seem surprising, given that business tacitly accepted the measure. Moreover, the visibility of the VAT is very low—consumers generally are not aware of how much VAT they pay—and the impact of the gradual one-point rate increase would be marginal. Therefore, it was highly unlikely that legislators would suffer punishment at the polls for passing the reform, whereas those who voted in favor could potentially claim credit for supporting social spending.

However, the choice of tax instrument gave the right a political opportunity to hurt the government by portraying the reform as incompatible with the Concertación's equity agenda, and thereby exacerbating tensions within the coalition, a tactic often used by the opposition (Alvarez 2005, author's interview).<sup>13</sup> Instead of applauding the government for choosing an efficient, non-distortionary tax, the right denounced the VAT as regressive and unfair. Seven of the 14 right senators who spoke during the debate on the reform emphasized these points, and two designated senators also complained that the VAT was regressive. For example, RN Senator Espina decried: “no es razonable proponer que los problemas económicos del programa Chile Solidario y los de salud de la gente pobre se resuelvan sacándoles recursos a las personas que ganan menos.”<sup>14</sup> Designated Senator Cordero stated this point even more forcefully: “subir el impuesto al valor agregado importa una crueldad incalificable y terriblemente desmoralizadora cuando la iniciativa proviene del grupo político que se jacta de defender los derechos de los más pobres.”<sup>15</sup> Other right senators attempted to turn the tables on the Concertación, blaming it for failing to make the tax system more equitable and for failing to reduce levels of indigence

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<sup>10</sup>See Avila (PRSD), Lavandero (PDC), Ominami (PS), Moreno (PDC), Adolfo Zaldívar (PDC), and Ruiz (PDC) in *Diario de Sesiones del Senado, Legislatura 349, Sesión 8, July 2, 2003*: 58, 60-63, 77, 103-104, 147, 180.

<sup>11</sup>*Ibid.*: 104.

<sup>12</sup>The diesel tax was rejected 24 to 22 and the tobacco tax was rejected 23 to 21. Two Concertación senators—ex-president Frei and PSRD senator Avila—broke ranks on these taxes and contributed to their rejection. *Diario de Sesiones del Senado, Legislatura 349, Sesión 9, July 8, 2003*.

<sup>13</sup>The UDI senator explained: “a veces... lo que hace la oposición en estos proyectos, es marcar una diferencia muy fuerte, cosa que dentro de la Concertación se produzca ... un debate interno en que se den cuenta 'oye, lo que están diciendo, pueden tener razón...'” A dramatic example of this strategy occurred in 2007, when the Alianza voted against a tax incentive proposed by the Finance Minister and supported by big business that was highly unpopular within the ranks of the Concertación (Chapter 3).

<sup>14</sup>*Diario de Sesiones del Senado, Legislatura 349, Sesión 8, July 2, 2003*: 153.

<sup>15</sup>*Ibid.*: 38.

(notwithstanding years of Alianza resistance to redistributive policies).<sup>16</sup> These attacks placed many Concertación legislators in the uncomfortable position of justifying their support for a tax increase they in fact did not like.

Notwithstanding the right's opposition, linking to spending in combination with fiscal discipline arguments won the two designated senator votes that allowed the VAT increase to pass. Senator Zurita, for example, asserted: "votaré favorablemente en parte el proyecto, porque si lo rechazamos del todo vamos a privar a los pobres de Chile de recibir la ayuda que el Gobierno les piensa dar."<sup>17</sup> And Senator Vega explicitly acknowledged the need for fiscal discipline:

Subir el IVA, ...no es popular... pero ... ser indiferente ante un déficit significa inevitablemente, más tarde o más temprano, modificar otros impuestos más nocivos para el crecimiento... La estabilidad de una democracia se pone en riesgo cuando se desatan crisis macroeconómicas, que en algunos casos de América Latina pueden resultar extremas. Y también han existido situaciones de esa índole en nuestro país. Pero Chile ha dado un ejemplo en el ordenamiento de sus cuentas fiscales. Por ello, me parece que el proyecto, en lo general, se halla orientado dentro del modelo.<sup>18</sup>

In addition, Former Senate President Zaldívar (2007, author's interview) helped secure Vega and Zurita's votes by arguing that the alternative would entail increasing direct taxes, which they (like business) would have found more objectionable.

### ***Strategic Errors and Sub-Optimal Spending Program Characteristics***

Strategic errors made by the executive branch helped create political space for the right to oppose the VAT increase. First, the executive's tardy call for compensating revenue loss due to the free-trade treaties undermined the effectiveness of emphasizing fiscal discipline. Previous Concertación administrations had often included compensation within a single trade-tax reduction reform package. For example, a revenue-neutral 1998 reform reduced tariffs and increased excise taxes. Frei's Finance Minister was a strong advocate for reducing tariffs, but he refused to proceed until business and the right agreed to compensate the revenue loss (Aninat 2007, author's interview). In contrast, the free-trade treaties with Europe and the US moved forward with little if any discussion regarding the revenue loss they would entail. The government sought to portray these treaties as unqualified policy successes, and the Ministry of Foreign Relations, which had negotiated the treaties, argued against calling for compensation, anticipating that so-doing would detract from the political victory (author's interviews: Marcel 2006, Finance Ministry B 2005). The Ministry of Foreign Relations' position prevailed over the Finance Ministry's objections: "cuando se propusieron las leyes para ratificar los TLC al Congreso, no se dijo que se iba a compensar eso, y luego hubo que hacerlo a posteriori. Esa secuencia no fue muy feliz realmente," (Marcel 2006, author's interview). Increasing the VAT after the treaties had been approved rather than simultaneously allowed the right to oppose the VAT increase without jeopardizing tariff reductions. The executive's tardy emphasis on fiscal discipline also gave the right opportunity to question the government's assertion that the trade treaties did in fact entail revenue loss that required compensation. The right argued that growth spurred by free trade would generate additional tax revenue sufficient to offset the tariff cuts and made much of the government's prior silence on the issue of compensation. For example, an UDI senator asked rhetorically: "¿Por qué no nos informaron antes de votar a favor del TLC con Europa que a cambio se subirían los impuestos? Al contrario, consultada sobre el particular, la señora Subsecretaria de Hacienda afirmó en la Comisión de Hacienda que el tratado con Europa se financiaría con readecuación de gastos."<sup>19</sup>

Second, the weak nature of the link to social spending helped undermine the effectiveness of this reform strategy. The link to spending was purely discursive in nature. *Chile Solidario* and *Plan AUGE*

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<sup>16</sup>Ibid.: 123-126, 135.

<sup>17</sup>Diario de Sesiones del Senado, Legislatura 349, Sesión 8, 7/2/03: 23.

<sup>18</sup>Ibid.: 91.

<sup>19</sup>UDI Senator Matthei, Ibid.: 65.

(the health care reform) were legislated separately; indeed, these proposals were already advancing through congress when the VAT increase was proposed. Because the links to spending were relatively weak, it was easier for the right to oppose the VAT increase while still declaring support for the two social programs.

In addition, the social spending programs and the benefits they would provide, particularly *Plan AUGE*, were hard for the public to understand, which made it difficult to mobilize popular pressure in favor of the tax increase that would fund them. *Plan AUGE* entailed guaranteeing prompt attention and treatment for all citizens suffering from any of 56 specific diseases or disorders that accounted for 80% of health care spending (Borzutsky 2004: 19). The Concertación's leading tax expert, a former Finance Ministry official who had participated in almost all of the tax reforms proposed by the Aylwin and Frei administrations, observed that the health care reform's complexity made it difficult to legislate the VAT increase:

Cuando se discutía esto [the VAT increase], nadie sabía en qué consistía la AUGE. Era muy difícil de explicar. ...un seguro para algunas enfermedades, con un fondo solidario, separado el sector público del sector privado, y qué enfermedades... ya la gente, la mitad se fue, no se interesó. (Marfán 2005, author's interview)

In fact, surveys conducted in 2002 indicated that a very high percentage of Chileans—49% to 70%—were not familiar with the basic elements of *Plan AUGE* (Dávila 2005: 47). Errors of communication exacerbated these problems. In the initial stages, the government tended to explain this inherently complicated reform in very technical terms that were not easily assimilated by the public (Dávila 2005: 47, Marfán 2005, author's interview).

Further, the benefits provided by *Plan AUGE* would materialize at an unspecified time in the future. Ultimately, Congress did not approve *Plan AUGE* until a year after the VAT increase, and thanks to continued funding shortfalls, the reform had to be phased in gradually. While tighter links to spending and benefits that were easier to understand and more immediately realizable would not necessarily have neutralized right-party opposition, these factors probably would have made it more costly for the right to vote against the reform.

### **Preserving the VAT Increase in 2006**

In 2006, the newly elected Bachelet administration sought to make the 2003 VAT increase permanent in order to fund pension increases for low-income groups. This time, the executive linked the tax reform as tightly as possible to social spending, making the pension increase contingent on maintaining the VAT rate at 19%. Moreover, the spending side of the reform entailed immediate and easily understood benefits. Although these benefits were targeted rather than widespread,<sup>20</sup> they enjoyed broad popular legitimacy. However, despite the much better design of the linking strategy and a spending-side that was more conducive for pressuring legislators, the tax-side of the reform secured no right votes; the VAT measure passed thanks to the Concertación's slim, first-time majority in the Senate.

This experience demonstrates that linking to spending, even when optimally executed, is not sufficient for mitigating right opposition; other factors may give the right political space to reject tax increases. As in 2003, the right sought to capitalize politically by exacerbating manifest discontent within the Concertación regarding the executive's choice of tax instrument. During the congressional debate on the bill, six Concertación senators either stated their preference for or called attention to other funding options.<sup>21</sup> Likewise, nine out of fourteen right senators who spoke during the debate derided the VAT as regressive, unfair, and harmful for the poor,<sup>22</sup> notwithstanding the fact that both of the right's presidential

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<sup>20</sup>About 1.2 million people would receive benefits from the pension increases (Mensaje 25-354, March 31, 2006: 8).

<sup>21</sup>Other options mentioned included restricting the use of a regressive VAT benefit for the construction of homes (Chapter 4, Part 5) and reducing evasion associated with the large gap between the corporate and personal income tax rates (Chapter 3). See Senators Muñoz Barra, Ominami, Gazmuri, Avila, Gomez, and Navarro in *Diario de Sesiones del Senado, Legislatura 354, Sesión 36, April 11, 2006*: 43, 68, 84, 92, 124, 142. Nevertheless, all Concertación senators voted for the reform as in 2003.

<sup>22</sup>*Diario de Sesiones del Senado, Legislatura 354, Sesión 36, April 11, 2006.*

candidates, as well as Bachelet, had made clear during the 2005 campaign that they would keep the VAT rate at 19% if elected (AFICHE 2005, Bachelet 2005: 35).

The economic context provided additional leeway for the right to oppose the tax increase, tight links to social spending notwithstanding. Thanks to unprecedented copper prices, state coffers were booming, and a convincing case could be made that the government did not need the VAT revenue to finance pension increases. Six right senators articulated this argument.<sup>23</sup> Linking to spending thus proved less effective at minimizing opposition votes against the tax increase because the fiscal discipline argument that tied taxation to spending was less convincing for legislators and the public at large in this context, although its technical merit remained strong (see Chapter 3).

### **Linking Regressive Taxes to Progressive Spending During the Frei Administration**

A brief examination of two indirect tax increases under the Frei administration further illustrates the potential and limitations of linking to spending and emphasizing fiscal discipline. These strategies helped win approval from opposition senators and hence made tax increases possible during a period when the government held a minority in the Senate. Again, however, these strategies did not always win votes from the right parties.

#### ***1995 Excise Tax Increases to Fund Pensions***

In 1995, the Frei administration funded a pension increase by raising excise taxes on gasoline and tobacco. Direct taxes were off the agenda thanks to a tax invariability agreement negotiated with the right as part of the 1993 reform that made the 1990 corporate tax increase permanent (Chapter 3).<sup>24</sup> Links to spending in this case were very strong—the pension increases were contingent on approval of the excise tax increases. Moreover, the associated benefits were easy to understand and would take effect immediately after the excise tax increases became law. Although only the low-income elderly would receive the benefits, the pension increase enjoyed moral legitimacy that gave it widespread support (author's interviews: Marfán 2005, Aninat 2007).<sup>25</sup>

According to former Finance Minister Aninat and a key member of his team, Manuel Marfán, linking the excise tax increases to pensions facilitated reform. Aninat (2007, author's interview) asserted that the reform was easy to legislate since everyone favored increasing pensions. Marfán (2006, author's interview) recalled that the reform proved less controversial than the Finance Ministry originally expected for the same reason: “El tema de los pensionados era un tema . . . muy fácil hacer una discusión política.”

The reform achieved moderate success at winning opposition votes and containing debate over taxation. The reform passed with votes from four designated senators and one RN senator during the general debate. These legislators, along with an additional designated senator, also upheld the tax increases when they were voted on separately. Two of these designated senators suggested that links to social spending and fiscal discipline were important considerations in their vote choice. Senator Martin declared: “aun cuando estimo insuficiente el monto del reajuste de las pensiones sugerido en el proyecto y no comparto su financiamiento, participo de la justicia que fundamenta la iniciativa. Por ello voto a favor de la idea de legislar.”<sup>26</sup> Senator Thayer, for his part, asserted: “esta iniciativa . . . contiene una idea matriz

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<sup>23</sup>Novoa, Matthei, Coloma, Larrain, Orpis, Prokurika, in *Diario de Sesiones del Senado*, Legislatura 354, Sesión 36, April 11, 2006: 60, 88, 118, 125, 147, 159.

<sup>24</sup>The original 1995 proposal included a number of measures to close loopholes that had facilitated personal income tax avoidance, but the most important of these measures were not approved.

<sup>25</sup>*Diario de Sesiones del Senado*, Legislatura 331, Sesión 11, July 4, 1995. As in the case of the 2003 VAT increase, the executive framed the excise tax increases as consistent with the principle of vertical equity, on the basis that 84% of all gas was consumed by the top 20% (*La Segunda* May 22, 1995, *El Mercurio*, May 29, 1995). Diesel, which was used more pervasively in public transportation, was not affected. However, linking to spending was the primary strategy employed in this case; the proposal text did not include any estimates of tax incidence, nor did the Finance Minister present clear-cut vertical equity appeals to legislators in Congress.

<sup>26</sup>*Diario de Sesiones del Senado*, Legislatura 331, Sesión 11, July 4, 1995: 70.

cuyo verdadero propósito es un mejoramiento de las pensiones. Considerando esa idea matriz, mi voto no puede ser sino favorable.”<sup>27</sup>

However, strong links to spending notwithstanding, 14 out of 17 right senators and 4 out of 9 designated senators abstained during the vote on the reform in general,<sup>28</sup> and 12 right senators along with the four designated senators subsequently voted against the tax increases. In fact, they continued to oppose the reform even after it had been approved in the senate. Fifteen senators initiated an appeal to the Supreme Court on the basis that the articles establishing contingency of spending on tax increases violated the constitutional prohibition against earmarking.<sup>29</sup> The Supreme Court ruled in favor of the government, upholding the reform; however, the appeal demonstrated the limitations of linking taxation to spending. Even the threat of egg-throwing campaigns against the RN and UDI headquarters by organized retiree activists did not dissuade the right from challenging the reform.<sup>30</sup>

The right rejected the excise tax increases despite the government’s skilled use of links to spending in large part because it was the first time that the contingency linkage technique had been used, and the opposition was quite concerned regarding the precedent that would be set for future reforms. As Marfán (2006, author’s interview) recalled:

Fue una jugada de ajedrez de este artículo, que sorprendió la oposición, que no le gustó para nada. Porque tu lo ponías en un pie muy forzado. Por eso fue que yo recuerdo que protestaron *mucho* por esto. Y ellos no tienen iniciativa en material tributaria. Así que no puedan proponer una redacción distinta.

The right recognized that contingency could be a potent strategy for passing tax increases and therefore challenged its appropriateness and legality, both on the senate floor and in the courts.

### ***The 1997 VAT Increase to Fund Educational Reform***

Linking tax increases to spending proved more successful at winning opposition votes and containing conflict over taxes in 1997, when the Frei administration proposed to fund an educational reform by making the 1990 VAT increase permanent, rather than allowing the rate to revert to 17%. In this case, extenuating factors such as concern over legislative precedents or opportunities to divide the governing coalition were not relevant, and the right’s greater acceptance of the tax reform can be attributed to effective strategy and proposal design.

As in 1995, links to spending were strong, and the benefits provided were highly conducive for pressuring legislators. Although social spending was not made formally contingent on preserving the VAT increase, the reform package legislated the full details of the educational reform. The reform would take time to implement (the government anticipated a maximum of six years), but the benefits were easy to understand—the centerpiece entailed lengthening schooling for children from a half day to a full day. At that time, many schools held classes for one set of children in the morning and another set in the afternoon, and siblings may have had to attend school during different shifts. As Marfán (2005, author’s interview) explained: “es una grande reforma, pero muy simple de explicar. Tu dices ‘jornada escolar completa’ y toda las personas ... saben exactamente qué significa. Significa almueros escolares, significa [que la madres pueden trabajar]...” Surveys commissioned by the government demonstrated high levels of popular support—88-90%—for maintaining the VAT rate at 18% in order to fund the educational reform (Brunner 2005, author’s interview).

Thanks to the clarity and popularity of the benefits and inclusion of financing and spending in the same reform package, the strategy of linking to spending proved highly effective. Marfán (2005, author’s interview) recalled: “Hubo algunos al principio que dijeron ‘no, por que nunca voy a votar a favor de tener impuestos mas altos’... Para nosotros fue muy facil decir ‘mire, señoras y señores, este señor no quiere tener la reforma educacional.’” The Former Minister of Education made similar observations:

<sup>27</sup>Ibid.: 87. Thayer further declared: “Ante la negativa de éste a aceptar otra forma de financiamiento, no puedo hacer otra cosa que votar favorablemente la que ha propuesto...”

<sup>28</sup>Two right senators and one designated senator were absent.

<sup>29</sup>Oficio 1043, Cámara de Diputados, July 31, 1995, *La Epoca*, June 9, 1995.

<sup>30</sup>*La Epoca*, July 13, 1995.

“para eso necesitábamos más dinero y dijimos ‘si no nos aprueban mantener el IVA, no hacemos esto.’ Es una presión fuerte,” (Arellano 2005, author’s interview).

The 1997 reform was highly successful at winning opposition votes and minimizing debate over taxation. The right unanimously supported the reform package during the general debate, and the tax-side proved relatively uncontroversial. Only three out of the 13 opposition senators who spoke on the floor complained about the financing measure.<sup>31</sup> In contrast, in 1995, 13 out of the 19 opposition senators who spoke objected to the excise tax increases. And in 2003 and 2006, all of the right and non-Concertación designated senators who participated in the debate expressed their opposition to the tax increases.

In contrast to the 2003 and 2006 VAT reforms, in 1997, the right had little opportunity to exacerbate discontent within the Concertación by denouncing regressive taxation. The opposition was manifestly to blame for the fact that the executive had resorted to the VAT, because the 1993 tax invariability agreement with the right precluded direct tax increases during that period. Consequently, there was less dissent within the Concertación over the choice of tax instrument than in 2003 and 2006. Of course, the options preferred by the Concertación’s left wing were off the executive’s agenda in 2003 and 2006 because of anticipated objections from the right and designated senators. However, the right’s opposition to direct tax increases was in effect “on the record” during the Frei administration because of the tax invariability agreement, whereas during the Lagos administration, blaming the right for the executive’s choice of tax instrument entailed counterfactual arguments.

**Figure 4.2.1: Regressive Taxation: Concertación Discontent and Alianza Objections in the Senate**

	<b>Fraction of Concertación Senators Expressing Discontent over Regressive Taxation*</b>	<b>Fraction of Alianza Senators Denouncing Regressive Taxation**</b>
1995: Excise Tax Increases	1/21	4/17
1997: Made 1990 VAT increase permanent	0	1/17
2003: VAT Increase and Excise Taxes	6/24	9/18
2006: Made 2003 VAT increase permanent	6/20	9/17

\*Denominator corresponds to total Concertación Senate seats (including Concertación-designated senators).

\*\*Denominator corresponds to total Alianza Senate seats (excluding designated senators).

Sources: Diario de Sesiones del Senado: Legislatura 331, Sesión 11, July 4, 1995, Legislatura 335, Sesión 31, Sept. 3, 1997, Legislatura 349, Sesión 8, July 2, 2003, Legislatura 354, Sesión 36, April 11, 2006.

Figure 4.2.1 above displays the correlation between manifest discontent within the Concertación over regressive taxation and Alianza objections based on the regressive nature of the tax instruments. Four right senators complained about the regressivity of the 1995 excise tax increases<sup>32</sup> and one UDI

<sup>31</sup>The right petitioned to set the VAT at 17.5% rather than 18% but did not suggest eliminating the increase entirely. This modification was inadmissible because of exclusive executive initiative on taxation. Had the right presented a petition (*indicación*) to eliminate the VAT measure, the Concertación may have been forced to hold a vote on that article of the reform. Diario de Sesiones del Senado, Legislatura 335, Sesión 31, Sept. 3, 1997: 133-149.

<sup>32</sup>Piñera, Otero, Siebert, and Urenda, in Diario de Sesiones del Senado, Legislatura 331, Sesión 11, July 4, 1995.

senator decried the 1997 VAT on the same grounds,<sup>33</sup> but the right issued significantly fewer tax-regressivity objections in these cases than in 2003 and 2006, when Concertación legislators expressed greater discontent over regressive tax increases.

### **Comparative Perspective**

I have argued that an optimal linking to spending strategy requires a social program that provides clear and timely benefits, as well as a strong linkage technique. The four reforms examined here varied on both accounts (Figures 4.2.2, 4.2.3). Overall, the 1995, 1997, and 2006 reforms employed the most optimal strategies, whereas the 2003 reform was least optimal (Figure 4.2.3).

The government's success at minimizing debate over and opposition votes against the tax-side of the proposed reforms also varied across the four cases (Figure 4.2.4). The 1997 reform was the most successful overall, followed by the 1995 reform. The 2003 and 2006 reforms achieved little success on either account, although the executive did manage to secure the passage of each reform in congress thanks to disciplined Concertación voting, and support from two right-aligned designated senators in 2003.

As illustrated in Figure 4.2.5, there is no strict correlation between the optimality of the linking-to-spending strategy and success at minimizing debate over and opposition votes against tax increases. An optimally-designed linking strategy could be effective, as in the case of the 1997 reform. However, even with optimal linking, a reform did not necessarily win opposition votes or even contain debate over taxation. Other factors occasionally encouraged the right to vote against tax increases that would fund popular spending programs. In 1995, right opposition stemmed from concerns regarding the precedent of a new linkage technique: contingency. In 2006, the context of extraordinary fiscal surpluses thanks to booming copper prices created space for the right to oppose reform by weakening the persuasiveness of the fiscal discipline argument on which linking taxation to spending depended. And opportunity also arose for the right to seek political advantage by exacerbating dissent within the Concertación regarding the choice of a regressive tax instrument to finance spending. The 2003 reform, meanwhile, was over-determined for low levels of success, given both the weak design of the linking strategy and the political opportunity for the right to exploit Concertación discontent over the regressive tax increase.

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<sup>33</sup>Larraín in Diario de Sesiones del Senado, Legislatura 335, Sesión 31, Sept. 3, 1997: 47.



**Figure 4.2.2: Benefit-Side Conduciveness for Pressuring Legislators**

	Main Social Program Funded	Benefit Characteristics		Conduciveness for Pressuring Legislators
		Clarity	Timing	
1995: Excise Tax Increases	Pensions	High	Immediate	Very High
1997: Made 1990 VAT increase permanent	Education: Full School Day	High	Medium-Term	High
2003: VAT Increase and Excise Taxes	Health Care	Low	Medium-Term	Low
2006: Made 2003 VAT increase permanent	Pensions	High	Immediate	Very High

**Figure 4.2.3: Optimality of Linking Strategy**

	Benefit-Side Conduciveness for Pressuring Legislators	Linkage Strength and Technique	Optimality of Linking Strategy
1995: Excise Tax Increases	Very High	Very Strong: Contingency	Very High
1997: Made 1990 VAT increase permanent	High	Strong: Inclusion	High
2003: VAT Increase and Excise Taxes	Low	Weak: Discursive	Low
2006: Made 2003 VAT increase permanent	Very High	Very Strong: Contingency	Very High

**Figure 4.2.4: Success at Minimizing Opposition Votes Against and Debate on Taxation**

	Fraction of Opposition Legislators Voting Against Tax-Side of Proposal†		Fraction of Opposition Senators Voicing Tax Complaints††	Overall Success
	Right Senators	Designated Senators°		
1995: Excise Tax Increases	High: 12/17 (4 absent)	Low: 1/9 (3 absent)	Moderate: 13/26	Moderate
1997: Made 1990 VAT increase permanent	NA (no separate vote)	NA (no separate vote)	Low: 3/26	High
2003: VAT Increase and Excise Taxes	Very High: 18/18: VAT 18/18: Excises	Moderate: 3/6: VAT High: 5/6: Excises	High: 19/24	Low
2006: Made 2003 VAT increase permanent	Very High: 17/17	NA (no designated senators after 2005)	Very High: 14/17	Low

†Votes corresponding to debate “in particular” on the tax measures and/or to formal petitions proposed by the right to eliminate the tax measures.

°Non-Concertación designated senators only.

††During discussion of reform package in general. Denominator corresponds to total right and non-Concertación designated senators.

**Figure 4.2.5: Optimality of Linking Strategy, Contextual Factors, and Strategy Success**

	Optimality of Linking Strategy	Contextual Factors	Strategy Success
1995: Excise Tax Increases	Very High	Opposition concern regarding precedent of contingency strategy	Moderate
1997: Made 1990 VAT increase permanent	High	NA	High
2003: VAT Increase and Excise Taxes	Low	Opportunity to exploit discontent within Concertación regarding regressive tax instruments	Low
2006: Made 2003 VAT increase permanent	Very High	Opportunity to exploit discontent within Concertación regarding regressive tax instruments; Major fiscal surplus.	Low

### **Part. 3. Addressing the Problem of Under-Taxation of the Mining Sector**

In 2005, the Lagos administration legislated a new tax on mining designed to capture extraordinary profits associated with natural resource extraction. This reform represented the culmination of a long series of largely frustrated efforts on the part of Concertación policymakers to resolve the problem of under-taxation in the mining sector. Business' instrumental power and institutional constraints inherited from the dictatorship thwarted the Concertación's efforts to implement the most logical technical solution in the 1990s. Thereafter, policymakers sought to craft alternative proposals that would be more politically feasible. This section examines this long-term policy process and analyzes how the Lagos administration ultimately managed to pass the 2005 reform.

After 2002, the political climate grew increasingly favorable for reform, thanks to persistent activism on the part of Concertación legislators who sought to impose a royalty on copper, and a high-profile case of blatant tax avoidance that mobilized public opinion against the privately owned mines and incurred the executive's wrath. The Lagos administration's first royalty proposal was defeated in 2004, but its second proposal, which took the slightly different form of a "specific tax on mining," passed in 2005. The second proposal succeeded whereas the first had failed largely because closer proximity to the December 2005 presidential election placed greater pressure on business and the right to accept the reform. Both proposals enjoyed strong inherent legitimacy, arising from nationalistic sentiments that copper wealth belonged to the Chilean people. However, right party legislators who opposed taxing the mining sector faced greater political costs to voting against the extremely popular reform in 2005 than they had in 2004. Recognizing that pressure to pass a royalty could only grow more intense during the electoral campaign, business and the right made a strategic decision to accept the second reform, which they viewed as the lesser evil compared to its precursor.

The inherent legitimacy of the mining tax made the reform politically viable in a context of intense opposition from business and the right as well as institutional constraints that granted the mining sector protections against increased taxation. Nevertheless, the political space that inherent legitimacy created was limited. Although the 2005 reform was modest at most in terms of its impact on the sector, it entailed a major political battle, despite the reform's overwhelming popularity. In addition, the reform came at the cost of precluding further tax increases on the still quite privileged mining sector for the next decade.

#### **The Causes of Under-Taxation in the Mining Sector**

Copper mining in Chile had been nationalized under the presidency of Allende with widespread popular approval and unanimous support in Congress in 1971. The market-oriented military government did not privatize CODELCO, the nationally-owned copper company, but it laid the groundwork for private investment to enter the sector. International companies entered Chile in the late 1980s to develop new copper fields, and foreign investment accelerated in the early 1990s. By 2002, CODELCO controlled only 33% of copper production (SII 2003: 31).

To encourage investment, the dictatorship rewrote the mining code in terms that were very favorable to private companies. Mining concessions were treated as close to private property as possible given that the Constitution clearly asserted state ownership of subsoil copper (Finance Ministry D 2005, author's interview). Further, mining investors were allowed to constitute their enterprises as partnerships (*sociedades de personas*), which enjoyed special tax privileges related to the use of accelerated depreciation, rather than corporations (*sociedades anónimas*). Accelerated depreciation allows companies to defer tax payments, by applying future depreciation of assets against current tax obligations. In the case of corporations, accelerated depreciation applies only to the corporate tax, not to taxes on dividends. In the case of partnerships, however, investors are allowed to apply accelerated depreciation against the taxes they owe on distributed profits—the income tax for Chilean citizens, or the withholding tax for foreigners. Because mining companies' initial investments were so large, accelerated depreciation allowed them to register huge losses, such that they would not pay corporate tax for many years. Meanwhile, investors in these companies could withdraw actual profits without paying individual taxes,

thanks again to the use of accelerated depreciation. This arrangement amounted to “a credit at zero interest rate for the personal consumption of foreign investors,” as Lagos’ Finance Minister explained: “Normally what you do with accelerated depreciation is you postpone the tax provided that the firm reinvests money. The way this law was written didn’t require the firm to reinvest the money. It could be sent abroad to finance a yacht... That was nonsense,” (Eyzaguirre 2007, author’s interview).

Accelerated depreciation was one of many tax benefits granted to mining companies that the dictatorship froze in place through Decree Law 600. This law, which held the status of a treaty signed between the state and individual investors, guaranteed invariability of tax legislation for mining companies who were signatories for a period of twenty years. Of the largest ten privately owned mines in Chile, which together accounted for 59% of copper production, eight mines had signed contracts with DL 600 protections, and eight mines were organized as partnerships rather than corporations (SII 2003:35).

In addition to these special tax benefits, which in many cases ensured that companies would not owe any taxes for a decade or more, two avoidance mechanisms commonly used by multinational corporations around the world allowed mining companies to further reduce their tax obligations. First, companies could distribute profits to shareholders in the form of interest payments on loans from the parent company or related enterprises. Interest payments, which in practice amounted to profits for shareholders, were subject to a tax of only 4%, whereas dividends distributed directly to shareholders who invested in the company were taxed at 35%. In order to avoid the much higher tax on distributed profits, mining companies often maintained very high debt-to-equity ratios. Of the largest ten private mines, four were considered to be sub-capitalized in 2002 (SII 2003: 37). Second, companies could manipulate transfer prices to reduce their tax burden. This scheme involves contracting services or buying inputs from a related company abroad at above-market prices; these inflated expenses are then deductible (in some percentage) from the Chilean subsidiary’s income tax base as costs necessary for producing profits.<sup>1</sup>

Thanks to the tax benefits and avoidance mechanisms described above, only two of the largest ten private mines had paid corporate income taxes between 1995 and 2003, and only three had paid taxes on distributed profits (SII 2003: 33). Accelerated depreciation and sub-capitalization cost the state an estimated total of USD 335 million from 1991 to 2003 in corporate taxes (SII 2003: 40) and USD 108 million in taxes on distributed profits (SII 2003: 36) from the largest ten mines.

### **Obstacles to Reform: Instrumental Power and Institutional Constraints**

Business’s strong instrumental power, in particular cross-sectoral cohesion and partisan linkages, created significant obstacles to resolving the problem of under-taxation in the mining sector. Business cohesion extended to the mining sector, despite the fact that most of the largest private-sector mines were foreign-owned and represented by a separate association, the Consejo Minero, which did not belong to the CPC. On the one hand, the CPC and the domestic business community defended the mining sector—multinationals included—based on neoliberal ideological principles, arguing that increasing taxation of these companies either by creating a new tax or by eliminating their tax benefits constituted discrimination against a particular sector. On the other hand, some businessmen held shares in or owned mines belonging to the Consejo Minero as well as mines affiliated with SONAMI, which represented smaller, domestically-owned private mines and did hold membership in the CPC.<sup>2</sup> These indirect organizational linkages counteracted the foreign-owned mining sector’s formal organizational isolation (Mining Sector A 2005, author’s interview). The foreign companies also benefited from the broader business community’s partisan linkages, despite the fact that foreign owners were not a political constituency for the right parties, thanks to the right’s small-state, low-tax ideology and the presence of domestic ownership in the copper sector.

Government initiatives to curtail the mining companies’ tax benefits therefore met with rejection from the business associations and strong opposition from the right (the UDI most consistently).

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<sup>1</sup>Similar avoidance mechanisms were widely used by grain exporters in Argentina, as will be discussed in Chapter 5.

<sup>2</sup>For example, Jean Paul Luksic, the president of Antofagasta Plc and an executive board member of the Consejo Minero, also held an individual membership in Sonami (See [consejominero.cl](http://consejominero.cl), [sonami.cl](http://sonami.cl)).

Throughout the political conflict that developed over mining taxation, these actors maintained that altering the mining sector's tax burden in any way amounted to changing the rules of the game and would deter investment—notwithstanding Chile's comparative advantages that made copper mining highly profitable, as well as the very low tax burden imposed on mining companies compared to other countries,<sup>3</sup> which made it unlikely that moderate tax increases would affect investment.

Institutional constraints inherited from the dictatorship made reform even more difficult. First, the Mining Concessions law held constitutional status and could only be altered with a supermajority of four sevenths. This constraint augmented business's instrumental power by making it easier for their right party allies to block reform in Congress. Second, Decree Law 600 (DL 600) held treaty status and could not be violated without risking lawsuits in international tribunals (author's interviews: Finance Ministry C, D 2005). While governments with heterodox economic leanings in Bolivia and Argentina were undeterred by such risks when it came to regulating or taxing multinational firms, directly violating contract agreements fell outside the scope of what executive-branch Concertación policymakers were willing to consider. DL 600 strengthened the foreign mining companies' bargaining position. They simply would not have to pay tax increases that violated the terms of the DL 600 invariability clause unless they voluntarily chose to do so, and the executive would therefore have to negotiate any such agreement directly with the companies.

### **Successive Reform Attempts: the Search for a Politically Feasible Solution, 1998-2001**

The Concertación had attempted to address the problems with taxation of the mining sector beginning in the early 1990s. Finance Ministry tax experts proposed a logical and technically appealing solution to the problem of accelerated depreciation with respect to distributed profits in the mining sector: subjecting partnerships to the same tax rules that applied to corporations. This reform had a number of advantages: it simplified Chile's tax code, promoted horizontal equity across different kinds of companies and economic sectors, and addressed tax avoidance problems with partnerships outside as well as within the mining sector. Despite the Concertación's solid technical rationale for the reform, it was resoundingly opposed by business, the right parties, and conservative think tanks associated with these sectors. A key informant recalled that business and the right were “visceralmente contrarios” (Former Finance Ministry 2005, author's interview) to the reform. This modification was included in 1998 as part of an anti-evasion reform designed to fund a Frei administration pension increase,<sup>4</sup> but it had to be removed during negotiations with the right in the Senate. However, even if the measure had passed, it would have applied only to new investments in the mining sector, thanks to the protections offered by Decree Law 600.

The Frei administration also considered the possibility of a copper royalty in the late 1990s. Studies were commissioned and completed,<sup>5</sup> but no concrete initiatives were undertaken. First, the East Asian crisis had arrived, and the Finance Minister did not want to impose a new tax out of concerns regarding structural power: “empezó la crisis asiática, yo hubiera tenido que ser loco—employment and growth estaban cayendo—de encima, decidir poner un tax de esa magnitud,” (Aninat 2007, author's interview). Second, the Frei administration was politically weak during its final two years, so initiating a battle over taxes would not have been opportune. Moreover, the administration simply did not have time to undertake the reform so late in Frei's term (Aninat 2007, author's interview).

The Lagos administration tackled aspects of the mining sector tax problem as part of the 2000 Anti-Evasion Reform (Chapter 4, Part 1), with limited success. In light of the failures of successive attempts to

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<sup>3</sup>According to a study published by the Colorado School of Mines, copper mining profit margins in Chile were the highest among 19 countries analyzed, while effective tax rates imposed on copper mines were the lowest (Otto 2000: 2). The Fraser Institute's annual survey of mining companies placed Chile within the top three out of 85 countries most favorable for investment and exploration from 2001 to 2003. (See also: *El Mercurio*, Jan 11, 2004: “Las Movidas Tributarias del Gobierno,” *El Mercurio*, Aug. 15, 2004: “¿Gobierno enredado en su propia estrategia?” *El Mercurio*, Oct. 2, 2000: “Sofosa cuestiona propuesta de cambios a legislación tributaria”).

<sup>4</sup>Mensaje de Proyecto 44-337, April 20, 1998: 5.

<sup>5</sup>Aninat (interview 2007) solicited a study outlining the technical basis for a copper royalty from Jeffrey Sachs and his collaborators at Harvard.

implement the technically best solution to the accelerated depreciation problem, the administration devised a different approach: restricting the use of this tax benefit to the corporate tax rather than pursuing the broader reform of equalizing the tax status of partnerships and corporations. The reform package also imposed restrictions on debt-to-equity ratios, requiring companies to pay the 35% withholding tax on interest payments for debt exceeding three times the company's capital endowment.<sup>6</sup> These three reforms were ultimately approved in congress after some concessions to business and the right, which opposed the changes. However, Decree Law 600 limited these measures' effectiveness. The tax invariability clause protected existing investments from relinquishing accelerated depreciation for taxes on dividends, although these changes did prevent new mining investments from using this benefit.

### **Building Momentum for Reform: High Profile Tax Avoidance and Parliamentary Activism**

A high profile case of tax avoidance in the mining sector in 2002 and activism by a committed group of Concertación legislators generated growing pressure in favor of imposing a copper royalty. Although the executive did not take action until 2004, this pressure placed the issue of under-taxation in the mining sector squarely back on the agenda. Both Finance Ministry informants and mining sector informants identified these two factors as critical for understanding how the Lagos administration came to legislate a new tax on the mining sector in 2005 (author's interviews: Finance Ministry C 2005, M. Valdes 2007).

In 2002, Exxon's sale of the mine *Disputada las Condes* to Anglo American roused widespread popular outrage and condemnation from the government. *Disputada las Condes* had taken advantage of all the tax incentives the dictatorship had offered, and as a consequence it had paid no taxes to the Chilean state during its 24 years of operation.<sup>7</sup> Estimates of the tax burden the mine had legally avoided reached USD 200 million over its lifespan.<sup>8</sup> Adding insult to injury, the two multinationals arranged to conduct the monumental 1,300 million dollar sale "off-shore" so that they would not be liable for capital gains taxes in Chile. The corporations created subsidiaries in the Cayman Islands and Virgin Islands to carry out the transaction (Finance Ministry C 2005, author's interview).<sup>9</sup> In this manner, the multinationals would avoid paying USD 300 million in capital gains taxes.<sup>10</sup> Lagos (2006, author's interview) responded forcefully to the affront: "lo denunció el país y fue un momento tenso, duro... Y hablé con la gente de Anglo American y le dije, si usted hace esto, tu vas a tener problemas conmigo en Chile. Chile es un país serio." To force Anglo American to pay taxes in Chile on the capital gain, the executive legislated a special reform that was approved in July 2002. Accordingly, the multinational turned over a paltry sum of USD 45 million to the state, an amount that reflected the effect of other protections included in Decree Law 600 and the difficulty of determining exactly how much capital Exxon had invested in Chile, given that it had financed its projects primarily through debt to lower its income tax obligations (Finance Ministry C 2005, author's interview).<sup>11</sup>

Finance Ministry informants identified the sale of *Disputada* as a turning point that motivated more active consideration of a royalty as a solution to the problem of under-taxation in the mining sector (author's interviews: Finance Ministry C, D 2005, Marcel 2005). As Marcel (2005, author's interview) recalled:

Este ministerio había sido muy reticente a mirar el tema de la tributación minera, históricamente, pero yo diría que eso se mantuvo mas o menos así hasta el episodio

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<sup>6</sup>Basic but underspecified powers to control transfer pricing were also granted to the tax agency.

<sup>7</sup>Informe de la Comisión Especial Encargada del Estudio de la Tributación de las Empresas Mineras, Boletín No S/672-12, May 17, 2004; *La Tercera* Feb. 25, 2005: "Disputada de Las Condes paga por primera vez impuestos desde 1978."

<sup>8</sup>*Diario El Observador de Quillota*, May 22, 2002: "Disputada Eludió 'Legalmente' el Pago de 200 Millones de Dólares en Impuestos al Fisco."

<sup>9</sup>See also *Cooperativa.cl* Sept. 30, 2002: "Gobierno autorizó a Anglo American a comprar mina Disputada de Las Condes."

<sup>10</sup>*La Tercera*, Feb. 25, 2005: "Disputada de Las Condes paga por primera vez impuestos desde 1978," Informe de la Comisión Especial Encargada del Estudio de la Tributación de las Empresas Mineras, Boletín No S/672-12, May 17, 2004: 5.

<sup>11</sup>See also *La Tercera*, Feb. 25, 2005. According to the Mining Commission report, the tax paid was only USD 25 million after negotiations. Another source cited a figure of USD 36 million (*El Mercurio*, April 25, 2004: "Las filosas esquirilas del royalty").

de la venta de la Disputada de Las Condes a Angloamerican, porque ahí ya se dio una actitud demasiado oportunista de los inversionistas extranjeros, entonces eso reactivó todo el tema de la tributación minera, de porque la minería pagaba tan pocos impuestos, y luego eso se fue avanzando hacia el tema del royalty.

This episode also solidly installed the issue of mining sector tax abuses in the national consciousness: “el caso Disputada de Las Condes, causó muy mala, muy mala impresión en la gente... eso creó un ambiente muy malo, muy malo. ... A nivel de la opinión pública, el tema Disputada de Las Condes salía por los diarios todos los días,” (Finance Ministry D 2005, author’s interview).

The Disputada scandal also gave momentum to royalty activists in Congress. PDC Senator Jorge Lavandero had long sought to bring what he viewed as multinational pillaging of the copper sector to the national attention. As part of this campaign, he published two books on the subject: *La Quimera del Cobre* (1999) and *El Cobre No Es De Chile* (2001). Senators Carmen Frei (PDC) and Riardo Nuñez (PS), among others, proved loyal collaborators in Lavandero’s cause.

The year after the sale of Disputada, the royalty advocates achieved a significant step forward with the formation of a Special Senate Committee to study the problem of taxation in the mining sector. This committee was convened to placate Lavandero, who had threatened to hold up the Senate vote on mining legislation that the executive intended to correct a technical problem in the 2001 Anti-Evasion reform that would have delayed investment in a large new private mining project (Finance Ministry C 2005: author’s interview).<sup>12</sup> Over the next year, the Committee held exhaustive hearings on the issue that included testimony from mining companies, Finance Ministry authorities, and other experts. Its final report, over 450 pages long, was published in May 2004. This committee kept the royalty in the public eye, maintained pressure on the Finance Ministry to address the issue, and signaled to the mining sector that higher taxation was a concrete possibility (M. Valdes 2007, author’s interview).

Meanwhile, Concertación royalty activists had urged the executive to finance Chile Solidario, Plan Auge, and the costs of the free trade treaty with the US by imposing a royalty on copper instead of increasing the VAT rate. Ultimately, the PS conditioned their votes of approval for the VAT increase on a formal protocol with the executive that among other points obliged the Finance Ministry to study the possibility of a royalty (Finance Ministry C 2005, author’s interview).<sup>13</sup>

### **Executive Response: From Avoiding Conflict with Business To Endorsing the Royalty**

Given strong business power, the Finance Ministry did not view the idea of a royalty favorably until relatively late in Lagos’ term. In 2003, the Finance Ministry opted instead for a non-confrontational approach of negotiating a solution to the tax problem directly with the mining companies. But after those efforts failed, the Lagos administration actively pursued the goal of imposing a royalty on the copper sector.

The Finance Ministry did in fact consider the possibility of proposing a copper royalty in 2003 to fund Plan Auge and Chile Solidario, but the idea was discarded as politically infeasible. Informants emphasized that the 2000 Anti-Evasion reform and the 2001 corporate tax increase had been difficult political fights, and the executive was not inclined to instigate another major tax battle in 2003 (Eyzaguirre 2007, author’s interview). As one informant recalled: “estabamos todos desgastados. Estabamos nosotros desgastados, estaban los parlamentarios desgastados, estaba el país desgastado. Y en ese minuto, haber seguido con un royalty hubiera sido una locura,” (Finance Ministry B 2005, author’s interview). The Finance Ministry calculated that the government would not be able to win enough votes in the Senate to approve a copper royalty at the time (Finance Ministry C 2005, author’s interview), especially not one large enough to satisfy the prevailing revenue needs: “tendría que haber sido un royalty mucho más grande, con... dificultades mucho mayores a las dificultades ya importantes que tuvimos con los proyectos de royalty que hubo después,” (Marcel 2005, author’s interview). One informant also

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<sup>12</sup>See also Informe de la Comisión Especial Encargada del Estudio de la Tributación de las Empresas Mineras, Boletín No S/672-12, May 17, 2004: 6.

<sup>13</sup>See also *El Mercurio*, April 25, 2005: “Las filosas esquilas del royalty.”

expressed concerns regarding business's structural power—proposing a new tax in 2003 could have created negative market signals in the context of a still sluggish economy, whereas increasing an existing tax was less likely to alarm investors (Finance Ministry C 2005, author's interview).

After the 2003 VAT increase, the executive opted for what it viewed as a non-confrontational approach to solving the mining taxation problem (Finance Ministry C, D 2005, author's interviews): requesting that the mines protected under Decree Law 600 voluntarily renounce their tax privileges (especially the use of accelerated depreciation). In addition to containing conflict with the business sector, the Finance Ministry viewed this approach as technically preferable to legislating what many economists viewed as a sector-specific tax, which would complicate the tax system (author's interviews: Finance Ministry D 2005, Marfán 2005).

The Finance Ministry used the building pressure in favor of a royalty from Concertación activists to strengthen its bargaining position with the large foreign-owned mines, represented by the Consejo Minero. In exchange for renouncing their tax invariability privileges, the Finance Ministry assured the mines that it would not seek to implement a royalty.<sup>14</sup> If they did not accept this offer, the Finance Ministry warned that the executive would be forced to send a much harsher tax bill to Congress; as Eyzaguirre (2007, author's interview) recounted, he told the Consejo Minero: “the guys of the Concertación are going to come for you, and it will be much more costly, believe me.” That the parliamentary activists favored a much larger levy on the mines than the Finance Ministry considered appropriate was clear to all actors.

However, the mining companies refused to relinquish the Decree Law 600 protections. Finance Ministry informants attributed this decision to misperceptions on the part of the Consejo Minero regarding the executive's resolve to address the tax problem and an underestimation of the momentum that was building in favor of reform in Congress and among the general public (author's interviews: Finance Ministry C, D 2005, Eyzaguirre 2007). In the words of one informant, “No tomaron seriamente la amenaza” (Finance Ministry C 2005). A mining sector informant, in contrast, attributed the Consejo Minero's decision to a perceived lack of credibility of the government's promise that relinquishing tax invariability would preclude a royalty initiative, precisely because the mines recognized how much pressure was building in favor of reform (Mining Sector D 2005, author's interview): “el problema ... fue de que nadie les aseguraba, que después de la renuncia, no hubiera un proyecto de royalty que igual los afectara. Podía no servir para nada la renuncia.”

The mining companies' refusal to take the government's request seriously made initiating a royalty proposal imperative from the executive's point of view. The Finance Ministry lost patience with what was viewed as the Consejo Minero's delaying tactics. As one informant recalled, “hubo un momento allí donde ya como efectivamente, ese camino no confrontacional no iba a ninguna parte, se decide ingresar este proyecto,” (Finance Ministry C 2005). The Finance Minister explained the situation in blunt terms: “we were trying to negotiate with the mining sector—I said to them, why don't you voluntarily get rid of this awful accelerated depreciation facility. And I wait and I wait for an answer... So I definitely got mad and I said ok, I'm going to go for a royalty,” (Eyzaguirre 2007, author's interview).

### **The 2004 Royalty Proposal**

The Lagos administration's royalty bill proposed a modest new levy on the mining sector. Copper mines would be subjected to a 3% levy on annual sales, with exemptions for small companies that sold under 2,000 UTA's (about USD 1.3 million) per year.<sup>15</sup> The royalty would be phased in gradually; it would be considered a credit against the corporate income tax for three years. According to Lagos (2006, author's interview), the Finance Ministry calculated that the royalty would barely reduce the copper mines' profit margins from 20% to 19.5%.

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<sup>14</sup>*La Tercera*, Jan. 8, 2004: “Mineras analizan petición de Hacienda a cambio de cerrar discusión sobre royalty,” *La Tercera*, Jan. 10, 2004: “Gobierno buscará reanudar contratos con firmas mineras.”

<sup>15</sup>Mensaje 7/4/04. A rate of 1% would apply to non-metallic mining (salt for example); mines under the presumptive income tax regime were also exempt.



### ***Reform Design and Executive Strategies***

Strategic reform design aimed to circumvent obstacles associated with business power and institutional constraints. The moderate nature of the executive's royalty proposal served to counteract potential concerns over structural power. The Consejo Minero mounted a campaign to bring international pressure to bear on the administration aimed at creating concerns that the reform would deter investment.<sup>16</sup> For example, the chief CEO of BHT Billiton asserted in the Chilean press that the copper royalty would affect his company's investment decisions,<sup>17</sup> and several foreign ambassadors expressed concerns to the government.<sup>18</sup> However, the government was well-positioned to dismiss these pressures. For example, when the Australians complained to Lagos (2007, author's interview) about the proposed legislation, he responded: "si ustedes quieren, yo retiro este proyecto, y pongo el royalty que ustedes tienen en Australia. Mucho mas alto!" Minister of Mining Dulanto also dismissed concerns regarding structural power by emphasizing the minimal impact of the royalty on mining companies' high profits.<sup>19</sup>

This reform design also circumvented problems associated with Decree Law 600. The tax invariability clause did not apply to the royalty, which technically was not a tax: "nosotros estábamos gravando por la extracción de ese valor y no por la utilidad que generaba, y en consecuencia, no era un impuesto a la renta y como no era un impuesto a la renta, entonces no tengas invariabilidad," (Finance Ministry D 2005, author's interview).<sup>20</sup> If the proposal were approved, then all mining companies, including those that had so far escaped taxation, would be obliged to contribute more revenue to the state.

On the negative side, the royalty entailed altering the Mining Concessions Law. Passing the reform in congress therefore required a supermajority of four sevenths. Unless the government could win votes from at least four right-aligned senators, the legislation would not pass.<sup>21</sup>

However, the royalty's inherent legitimacy created a possibility for the executive to win the requisite supermajority. The royalty was remarkably popular, owing to nationalistic sentiments that copper wealth belonged to Chile and outrage that foreign companies appeared to be extracting this wealth for their own profit without compensating the state. A survey conducted in April 2004 found that 67% of citizens approved of applying a royalty to the big mining companies, while only 15% disapproved. This support was by no means confined to Concertación loyalists. An impressive 80% of respondents intending to vote for the RN favored the royalty, and fully 60% of respondents who expressed intention to vote for UDI approved of the royalty (CERC 2004). By August, when the proposal was discussed on the Senate floor, surveys estimated popular approval for the royalty at around 80%.<sup>22</sup> Given such high levels of popular support, the government had little need to make explicit appeals to nationalism for the sake of promoting reform; politicians on the right were well aware of the potential costs associated with voting

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<sup>16</sup>*El Mercurio*, May 24, 2004: "Mineras atacarán desde el extranjero."

<sup>17</sup>*El Mercurio*, June 21, 2004: "Cambiar las reglas hace más complicado venir hasta acá:"

"¿Esta situación tendrá impacto en las futuras inversiones de BHP en Chile?"

"La respuesta es sí, tendrá un impacto. No puedo decir cuánto, en qué dimensiones y qué cambiará. Siempre estamos evaluando dónde logramos el mejor retorno con el dinero que invertimos."

<sup>18</sup>*El Mercurio*, June 3, 2004: "Embajadas comienzan lobby para frenar el royalty minero."

<sup>19</sup>"Nadie puede creer que la aplicación de un royalty que implica bajar la rentabilidad sobre el patrimonio en menos de un punto, en el peor de los casos, puede tener un impacto en una empresa que quiere hacer una inversión en minería. No tiene un impacto que haga inviable las inversiones que están en carpeta," (quoted in *El Mercurio*, June 23, 2004: "A todos nos ha faltado capacidad para conversar y flexibilidad").

<sup>20</sup>See also *El Mercurio*, April 20, 2004: "El sector privado se lanza contra propuesta de royalty."

<sup>21</sup>The royalty also suffered from a technical drawback: because it approximated a tax on sales volume rather than profits, it would discriminate against companies with higher production costs, for example, those mining lower quality ore. The Finance Ministry was well aware of this drawback, which made the proposal vulnerable to attacks from business and the right on technical grounds; however, taxing sales rather than profits was imperative for avoiding the constraints imposed by DL 600.

<sup>22</sup>Diario de Sesión del Senado, Legislatura 351 Ordinaria, Sesión 16, Aug. 3, 2004. In July, a survey conducted by Times Research for the government found 74% approval for the royalty. *El Mercurio*, July 15, 2004: "Caso Correa enfrenta al Gobierno con el PS."

against the proposal. In fact, preliminary consultations suggested that up to 14 RN legislators might support the reform.<sup>23</sup>

If it were not for the royalty's tremendous inherent legitimacy, the executive probably would have been obliged to link the reform to social spending or other popular benefits in order to apply pressure on the right in Congress. In fact, the royalty proposal and the subsequent special tax on mining stand out among the tax increases considered in this chapter for the very diffuse and long-term nature of the associated spending-side benefits. The proposal destined revenue from the royalty to a new research and development fund (*Fondo de la Innovación para la Competitividad*):

Dada la naturaleza no renovable de los minerales, ante un eventual agotamiento de estos recursos se perdería una importante fuente de ingresos y bienestar para el país. Por lo tanto, es necesario destinar los recursos obtenidos ... a la creación de nuevos activos capaces de reemplazar permanentemente la capacidad generadora de ingresos de estos recursos minerales.<sup>24</sup>

According to the administration's diagnosis, Chile had under-invested in scientific and technological research, which was critical for development. Lagos (2006, author's interview) emphasized his conviction that copper provided extraordinary resources that should not be devoted to current expenditures, but to longer-term investment, an approach embraced by successful natural-resource rich countries such as Norway.

### ***The Failure of the Royalty***

Although the executive expected a difficult fight, the Finance Ministry believed sufficient votes could be won in Congress to pass the reform (author's interviews: Lagos 2006, Finance Ministry C 2005). However, the proposal failed to obtain the requisite supermajority. Intense opposition from business and the right, business's instrumental power, arising largely from partisan linkages, explain the royalty's failure despite its tremendous popularity.

Intense rejection from the mining sector arose not only out of systematic opposition to higher taxation but also due to concerns over property rights. The problem stemmed from the inconsistency between the Mining Concessions Law, which treated the concessions as tantamount to private property, and the Constitution, which asserted the state's ownership of copper resources. Notwithstanding the favorable terms for private enterprises written in the Mining Concessions Law, the text of the proposal emphasized that: "la Constitución Política de la República consagra ... el dominio absoluto, exclusivo, inalienable e imprescriptible de todas las minas para el Estado."<sup>25</sup> The proposal explicitly described the royalty as a fee for extraction of resources owned by the state:

...el Estado no recibe actualmente ninguna compensación por la extracción y venta de recursos valiosos que, según la Constitución, le pertenecen. En la actualidad, el concesionario minero aprovecha los recursos no renovables de la minería en forma gratuita... Esta situación equivale a un subsidio del Estado hacia los dueños de las empresas mineras.<sup>26</sup>

As a Finance Ministry informant recounted, the proposal's emphasis on state ownership: "Abrió una discusión que podía generar incertidumbre jurídica muy fuerte para el sector minero que era que se puede poner en duda incluso el que ellos tuviesen derecho a estas concesiones de por vida del yacimiento. Por ello se opusieron fuertemente a esto," (Finance Ministry C 2005).<sup>27</sup> Similarly, a private sector informant asserted: "la manera en que se había formulado ponía en duda el significado de la propiedad minera y eso las empresas mineras lo iban a defender hasta la muerte," (Tax Consultant 2005).

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<sup>23</sup>*El Mercurio*, June 22, 2004: "Persisten discrepancias sobre el contenido regional del royalty." *El Mercurio*, April 20, 2004: "RN apoya y la UDI aplaza una definición."

<sup>24</sup>Mensaje N° 126-351, July 5, 2004.

<sup>25</sup>Ibid.

<sup>26</sup>Ibid.

<sup>27</sup>See also *El Mercurio*, April 20, 2004: "El sector privado se lanza contra propuesta de royalty."

Business more broadly defended the mining sector's position. Although the Consejo Minero and SONAMI were the primary business actors involved in the political process, the CPC, and its president Juan Claro in particular, actively participated in the opposition campaign (author's interviews: Eyzaguirre 2007, Finance Ministry B 2005, Marcel 2005, Lagos 2006, Mining Sector C, D 2005, M. Valdes 2007, Urenda 2007).<sup>28</sup> As the CPC's former general manager recalled, "nosotros estábamos coordinado permanentemente con la SONAMI, para apoyarlo y para defender las posturas que ellos tenían," (Urenda 2007, author's interview). Claro made regular statements against the royalty in the press and worked to ensure opposition from right party legislators in Congress. In addition to principled solidarity with the mining sector, business was concerned that the royalty could set a precedent for similar levies on other natural resource sectors such as forestry or even salmon farming (author's interviews: Urenda 2007, Muga 2008), which were represented by SOFOFA. The construction sector, another influential member of the CPC, had strong economic linkages to the mining sector (Morandé 2005, author's interview). The broader business community was also concerned with the consequences of what was perceived as a change in the rules of the game for foreign investment codified in existing contracts. Horizontal equity considerations did resonate within the ranks of the domestic business community according to several observers (author's interviews: Finance Ministry D 2005, Beyer 2005); for example, an informant well connected to the business sector observed: "el mundo empresarial estaba un poco incómodo con este hecho de que estos sectores [la minería] no pagaban impuestos... Así que el apoyo que consiguieron no fue tan abrumador," (Beyer 2005, author's interview). In practice, however, such sentiments did little to detract from business solidarity. While the CPC was less active on the royalty than it had been in the case of reforms with manifest cross-sectoral impact (author's interviews: Urenda 2007, Consejo Minero 2005), the peak association's initiatives against the reform were nevertheless important from the mining sector's perspective (Mining Sector D 2005).

Given strong ideological objections to the royalty and pressure from business, the right proved willing to block the popular initiative. The UDI's arguments against the royalty coincided with those advanced by the private sector, and active opposition from the mining sector and the CPC may have helped align the right against the royalty. Several Finance Ministry informants commented on the extreme degree to which the UDI was willing to defend the interests of the mining sector (Finance Ministry C, D 2005, Former Finance Ministry 2005, Eyzaguirre 2007). Ultimately, the UDI voted in block against the royalty, and of the 14 potential RN supporters, only two deputies and two senators voted in favor of the proposal. Although the royalty won majorities in both houses, it failed to secure the elevated supermajority needed for approval.<sup>29</sup>

The royalty's massive popular support did give the right cause for concern regarding the consequences of voting against the reform. Municipal elections were approaching in October 2004, and press accounts highlighted the problematic timing, pointing out that right votes against the royalty could improve the Concertación's electoral prospects.<sup>30</sup> The right was also concerned that rejecting the royalty could prolong debate over taxation in the mining sector into the coming year, which could affect the 2005 presidential and parliamentary elections.<sup>31</sup> The Alianza endeavored to control political costs by presenting its own alternative royalty proposal before the government's bill reached the Senate floor (Alvarez 2005, author's interview), which would ostensibly demonstrate the party's agreement with the principle that the mining sector should be taxed more heavily.<sup>32</sup> A few Alianza legislators adjudicated

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<sup>28</sup>See also *El Mercurio*, April 20, 2004: "El sector privado se lanza contra propuesta de royalty," *El Mercurio*, June 11, 2004: "El royalty irá "a la brevedad" al Congreso," *El Mercurio*, June 23, 2004: "Empresas no se sentarán a negociar proyecto de royalty," *El Mercurio*, June 26, 2004 "Ricardo Claro se lanza contra royalty y regulación eléctrica," *El Mercurio*, July 9, 2004.

<sup>29</sup>The bill won 61 votes of approval with 41 negative votes and 8 abstentions in the House of Deputies (Diario de Sesiones, Cámara de Diputados, Legislatura 351a, Ordinaria, Sesión 19a, July 21, 2004). In the Senate, it received 26 votes in favor and 19 against; one RN senator and one UDI senator did not vote (Diario de Sesiones del Senado, Legislatura 351a, Ordinaria, Sesión 19a, Aug. 10, 2004).

<sup>30</sup>*El Mercurio*, April 25, 2004: "Las filosas esquilas del royalty."

<sup>31</sup>*El Mercurio*, April 23, 2004, *El Mercurio*, April 25, 2004.

<sup>32</sup>Eyzaguirre referred to the Alianza proposal as a "joke" in the press *El Mercurio*, Aug. 11, 2005.

between electoral pressures and sympathy with business's position against the reform by abstaining from the vote, while others framed rejection of the royalty as a defense of the mining regions, which would not receive any direct benefits from the executive's proposal.<sup>33</sup>

The executive may have been able to win more right votes had it conceded to legislators' demands that the resources be channeled to municipalities in the mining regions. Concertación legislators reported that devoting some portion of the royalty revenue to the mining regions could have won over a number of RN and even a few UDI votes.<sup>34</sup> However, the executive refused, maintaining the conviction that it would be an inappropriate use of resources. Lagos (2007, author's interview) rejected these demands as "demagogia máxima."

### **The 2005 Specific Tax on Mining**

In January of 2005, the executive presented a second initiative to increase taxation in the mining sector. In the wake of the royalty's failure, the Finance Ministry opted for a slightly different design: a "specific tax" on mining companies' profits of 5%. The tax base would be the same as the corporate tax base, with the difference that accumulated losses and accelerated depreciation of assets, among other costs, would not be deductible. Therefore, the specific tax on mining would constitute a real tax obligation, in contrast to the corporate income tax, whose base had been so eroded by tax benefits that many mining companies simply were not obliged to pay. As with the royalty, the specific tax would be phased in gradually, and the revenue would be devoted to a technical innovation fund.

The specific tax offered a distinct set of tradeoffs compared to its precursor. Politically, the specific tax offered several advantages. In addition to circumventing the Constitutional prohibition on reintroducing a proposal that had been rejected in Congress until a year had passed, the specific tax on mining avoided the institutional constraint that had contributed to the royalty's downfall—the specific tax, like any other tax, required only a simple majority for approval. The specific tax was also less threatening to the mining sector because it did not touch on the issue of property rights to mining concessions (Finance Ministry C 2005, author's interview).<sup>35</sup>

However, mining companies with Decree Law 600 protections could not be obliged to pay the new tax. To deal with this problem, the government included a new invariability clause in the proposal designed to entice these companies to pay the specific tax. Companies that relinquished the old invariability clause would pay a reduced specific tax rate of 4% instead of 5%, and they would be exempted from future tax increases for a period of 15 years.<sup>36</sup> The details of this incentive had to be negotiated directly with the Consejo Minero and representatives of the foreign companies to ensure that the companies would in fact opt to pay the new tax (Mining Sector A, author's interview).

### ***Success: Pre-Electoral Timing Forces Business and the Right to Compromise***

The specific tax on mining was approved 86 to 14 with 8 abstentions in the House of Deputies and 28 to 5 with 6 abstentions in the Senate. Although many right legislators continued to oppose the reform, 7 Alianza senators voted in favor, 6 abstained, and only one voted no. Business, meanwhile, implicitly accepted the reform. The Consejo Minero and the CPC denounced the specific tax; the CPC was in fact more active in this case compared to the royalty proposal (Mining Sector A 2005, author's interview, CPC 2005), given the greater potential for the mining tax to serve as a precedent for imposing other

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<sup>33</sup>See for example Pérez in Diario de Sesiones, Cámara de Diputados, Legislatura 351a, Ordinaria, Sesión 19a, July 21, 2004: 32.

<sup>34</sup>*El Mercurio*, June 22, 2004: "Persisten discrepancias sobre el contenido regional del royalty," *El Mercurio*, June 26, 2004: "Royalty, sin fecha para entrar al Congreso."

<sup>35</sup>The Lagos administration also preferred the specific tax on technical grounds because it applied to profits rather than sales. Finance Ministry informants and Lagos (2006, author's interview) himself viewed this design as more fair, given that companies with the same volume of sales can have very different profit margins due to different cost structures.

<sup>36</sup>The proposal established "la imposibilidad de aplicar al inversionista nuevos gravámenes específicos a la actividad minera, y la imposibilidad de establecer condiciones más desfavorables en cuanto a tasa y forma de cálculo del impuesto, por un período de 15 años" (Mensaje 230-352, Dec. 14, 2004: 5). This period was subsequently reduced to a still substantial 12 years.

sector-specific taxes in the future.<sup>37</sup> However, neither association lobbied actively against the legislation (author's interviews: Finance Ministry B, C 2005, Eyzaguirre 2007, Marcel 2005, M. Valdes 2005), and all of the large mining companies subsequently switched to the new invariability clause that entailed paying the royalty, upholding their end of the gentlemen's agreement reached with the executive branch (Mining Sector A 2005, author's interview).<sup>38</sup>

Closer proximity to the presidential and legislative elections induced both the right and business to accept the extremely popular reform. The specific tax went to the Senate floor in May of 2005; the elections would take place in December. Consequently, the anticipated political cost to the right of voting against the specific tax was significantly higher than in 2004. As a Finance Ministry informant observed: "es distinto que vota un parlamentario en contra cuando faltan dos años para ser reelegido a que tiene que votar un par de meses antes cuando está elejiéndose, cuando está votando además contra una cosa que había 80% de la ciudadanía que estaba de acuerdo," (Finance Ministry C 2005, author's interview). Even the UDI recognized that rejecting increased taxation of the mining sector could jeopardize its legislators' electoral prospects, particularly for those representing mining regions (Alvarez 2005, author's interview), where support for the proposal was particularly strong. In addition, the fate of the specific tax could have implications for the presidential campaign. The right anticipated that the executive would send an even harsher mining tax proposal to congress if the specific tax failed, because of the strong pressure from Concertación legislators as well as strategic electoral calculations. The right would either be forced to vote in favor of a proposal that it opposed even more strongly, or it would have to bear the significant political cost of rejecting a popular reform immediately before the presidential election. Voters would have little time to forget the right's position on the proposal and would be more likely to exact punishment at the polls. The Concertación's strategy in the 1999 election of sending a popular proposal to Congress that the right adamantly opposed—labor reform—was interpreted by the right as one of the causes of its electoral defeat, and the Alianza feared a repeat of this strategy. The right had been concerned over this possibility in 2004,<sup>39</sup> and these worries intensified in 2005 as the elections approached. Finally, voting in favor of the specific tax could neutralize political costs associated with the right's previous rejection of the royalty.<sup>40</sup> Given these considerations, the UDI did not give orders for its legislators to vote against the specific tax, breaking with its strategy of voting in block:

Este es una de las pocas materias tributarias y económicas en que la UDI partió de la base que aquí había libertad para votar. Nosotros siempre tratamos de encontrar una sola posición en materia de impuestos, en materia económica, porque sabemos que una de las fortalezas de la UDI es su unidad. (Alvarez 2005, author's interview)

Business's stance of reluctant acceptance reflected similar strategic considerations to those of the right; the private sector also recognized that legislators were under greater electoral pressure to accept the specific tax in 2005 and shared the same concern that the executive would retaliate with an even more objectionable reform proposal during the height of the presidential campaign if the specific tax were rejected. In addition, the mining sector viewed the specific tax as the lesser evil compared to the royalty, thanks to the fact that the Finance Ministry steered clear of the property tax issue. Informants from the private sector emphasized the above considerations:

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<sup>37</sup>Slippery-slope arguments were regularly expressed in the press, and also in interviews with business sector informants: "rompía con la neutralidad tributaria que existía en Chile. ...se elegía una actividad productiva: la minería, porque tenía una horizonte de rentabilidad importante... y nosotros pensamos que eso era un criterio no adecuado. Porque con el mismo criterio uno puede aplicar impuestos específicos a otro actividad. Y de hecho hasta el día de hoy, aparecen ciertos voces diciendo que hay otras actividades a los cuales también hay que ponerle un impuesto," (Muga 2008, author's interview). In addition, the mining sector sought higher-profile assistance from the CPC's in the aftermath of the royalty's close defeat (*El Mercurio* Nov. 8, 2004: "Reedición del royalty alerta a las mineras.")

<sup>38</sup>Minería Escondida at first declared that it would retain its old tax regime, which instigated a new round of conflict with the Finance Ministry. However, the issue was eventually resolved in the government's favor.

<sup>39</sup>*El Mercurio*, June 14, 2004: "Empresas mineras se juegan la carta política."

<sup>40</sup>As an UDI legislator reflected: "Creo que al final tuvo un costo bajo ...la confusion disminuye los costos... la confusion de todos los proyectos, de todas las discusiones ... hizo que al final la mayoría de la gente dijera 'bueno, hay un impuesto [a la minería],' [y] la mayoría de la oposición voto a favor," (Alvarez 2005, author's interview).

En el primero proyecto [2004] siempre hubo una intención de ir muy en contra de eso. Pero en el segundo, ya no había nada que hacer ...ya no valía la pena, porque esa resistencia pública no nos iba a servir. Se dieron cuenta las empresas mineras que no sacaban nada en nadar contra la corriente. Era un inútil. ...había que tratar de cerrar rápidamente el capítulo (Mining Sector D 2005)

La CPC... tuvo una posición pragmática. Vio de que este tema, no tenía mucha solución, y por lo tanto ni la CPC ni los partidos tradicionalmente apoyadores del modelo defendieron fuerte el sector minero. Porque políticamente era bastante malo y inviable el caso. (M. Valdes 2007)

Finance Ministry informants made similar observations:

Claramente se entendió que esta era la ultima posibilidad de algo razonable... tampoco era muy signifiactivo el cobro. Si este proyecto no se llagaba a aprobar, el gobierno ya está obligado a meter un proyecto de ley durísimo, y de una forma que la oposición votase en contra justo ante de las elecciones en contra un proyecto mucho mas duro, parecido tal vez a unos de los proyectos que hayan metido los parlamentarios que no tenían ninguna consideración respecto a certidumbre jurídico, ni derechos de propiedad. Entonces...hay un entendimiento claro por parte de los actores privados de que este era una oportunidad mas que nada para cerrarlo. ...porque la amenaza de que ... este proyecto sea rechazada, vernos forzado ingresar un proyecto duro justo antes las elecciones era demasiado obvio. (Finance Ministry C 2005)

At the end what we did was to convince the mining sector that to have that tax in that moment was better for them rather than to raise that as a campaign issue, because we did have some in the Concertación that wanted to go far beyond. .... So they knew that well, they are going to do it anyway, and the Concertación was very united. So we better do it now, the moderate one. (Eyzaguirre 2007)

Closer proximity to the national elections thus made the Finance Ministry's strategy of using the reform's immense popularity and pressure from the Concertación's left-wing to threaten the mining sector more effective.

### **The Outcome: Modest Revenue at the Cost of Major Conflict and No Future Tax Increases**

On several accounts, the 2005 reform can be considered a success—the new tax brought closure to a highly controversial issue that had plagued Concertación administrations for over a decade, and it mitigated the problem of mining sector under-taxation. After numerous failed reform attempts and modifications that had not adequately addressed the problem, the mines would now pay taxes based on their actual profit margins. Further, the specific tax on mining approved in Congress essentially achieved the executive's original revenue goal for the 2004 royalty (Eyzaguirre 2007, author's interview), which slightly exceeded what the mines would have paid had they accepted the Finance Ministry's bargain of relinquishing Decree Law 600 protections in 2003 (Finance Ministry D 2005, author's interview).<sup>41</sup> In addition, the new tax achieved a second major goal of the Finance Ministry (author's interviews: Finance Ministry C, D 2005): eliminating uncertainty that could have affected future investments: “se elimina de la discusión para adelante y ya no hay más este fantasma del royalty dando vuelta. ...despejar una incógnita para proyectos de largo plazo es un tema muy importante para los inversionistas” (Finance Ministry D 2005).

However, the specific tax was quite modest in terms of its anticipated revenue capacity and its impact on the highly profitable mining sector. Revenue estimates at prevailing copper prices were around

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<sup>41</sup>The major concessions negotiated with right and PDC legislators in congress—increasing the exemption level to exclude nationally-owned mining companies from the tax—did not entail a significant revenue loss, although Lagos and his technical team found this modification highly objectionable on principal, given that several of the mines exempted could hardly be classified as small or medium enterprises (author's interviews: Lagos 2006, Finance Ministry C 2005).

USD 126 million dollars per year.<sup>42</sup> The fact that the specific tax on mining ultimately produced far more revenue than anticipated thanks to the dramatic increase in copper prices after 2005 does not detract from this point. Lagos (2006, author's interview) himself referred to the tax as "muy modesto." The mining sector recognized in retrospect that they had secured a very favorable deal (author's interviews: Mining Sector D 2005, M. Valdes 2005). As Lagos' Finance Minister recounted: "now informally they say to me: oh, how good the royalty law [the tax on mining] was. Imagine [if] it would have been a campaign issue. It would have been not 4% or 5%, it would have been 12%." Had the tax been legislated after copper prices skyrocketed, pressure from the Concertación and public opinion to secure a more significant contribution from the mining sector would have been even greater. In the words of a mining sector informant: "mirándose hacia atrás, fue muy oportuno hacerlo. Nunca nadie [pensaba] que el precio de cobre iba a dar el salto que dio. ...Haber cerrado este tema en ese momento fue muy oportuno. Muy, muy, oportuno," (M. Valdes 2007, author's interview).

The specific tax also came at the cost of precluding further tax increases on the large copper mines for twelve years, thanks to the new tax invariability clause. While some Finance Ministry informants were quite satisfied with the outcome of the 2005 reform (Finance Ministry C, D 2005), others viewed it in less sanguine terms, precisely because of the invariability clause: "Creo que fue un logro pequeño. Sobre todo porque hubo que hacer demasiadas promesas contra tan poco. Se recuadra muy poco, y prácticamente hubo que firmar con sangre que nunca más se iba a hacer... La verdad es que terminamos con algo muy pequeño," (Finance Ministry B 2005, author's interview). The inconvenience of the invariability clause came to bear in 2010 following the major earthquake that rocked Chile. Increasing taxation of the copper sector, which was still enjoying windfall profits from soaring international copper prices,<sup>43</sup> could have been a convenient way to raise revenue needed for reconstruction with a relatively low impact on the domestic economy.<sup>44</sup>

Finally, the reform entailed a long and difficult battle with business and the right. The political conflict surrounding the issue of the mining taxation, which dated back to 1998, intensified in 2003 and was not resolved until 2005. Informants identified the royalty as one of the most difficult and controversial tax reforms of the Lagos administration; Lagos (2006, author's interview) himself asserted that it was *the* tax reform that business and the right fought hardest against during his term.

Political obstacles associated with business's instrumental power and institutional constraints inherited from the dictatorship precluded more significant reform. As Lagos (2006, author's interview) recounted: "Poner una cifra mayor, te van a rechazar. Entonces prefiero una cifra menor pero que el proyecto salga." The executive's own technical preferences also limited the political space for reform. Had the executive made taxation of the mining sector a campaign issue and mobilized popular pressure through more active appeals to nationalism, the Concertación may well have been able to secure a larger tax increase. However, Lagos (2006, author's interview) perceived that this option would have incurred greater pressure—both within the Concertación and from the right—to allocate the revenue to the mining regions, which ran counter to his convictions that the revenue should be invested in long-term, nationally-oriented development. Given these constraints, inherent legitimacy created a relatively narrow space for reform despite the overwhelming popularity of taxing the mining sector.

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<sup>42</sup>Segundo Informe de las Comisiones de Hacienda y de Minería y Energía, Boletín No. 3.772-08, May 18, 2005: 28. Finance Ministry informants subsequently cited estimates of USD 150 million per year (Finance Ministry C, D 2005).

<sup>43</sup>Copper prices fell from the end of 2008 to their pre-2005 values, but recovered to the high 2007 values by early 2010.

<sup>44</sup>To the surprise of many observers, the newly-elected Piñera administration did in fact propose to raise additional revenue to fund reconstruction after the 2010 earthquake by increasing the copper tax, subject to the constraints of the invariability clause—once again, the mining companies would have to be enticed to accept higher taxation in the present in exchange for additional tax benefits in the future. Oscar Landerretche, Frei's 2009 campaign advisor, likened the government's proposal to a request for a loan from the mining sector. *El Mercurio*, April 27, 2010: "No hay alza impositiva, sólo una reasignación tributaria." Since these developments took place as this dissertation was about to be filed, a full analysis of Piñera's proposed copper tax increase and the extent to which his administration succeeds in raising additional revenue from the sector despite the invariability clause constraints remains pending.

## Part 4. Eliminating “57 bis,” a Regressive Income Tax Benefit

After 16 years in power, the Concertación finally managed to eliminate a regressive tax benefit for owners of new-issue stocks that amounted to a state subsidy for the very rich. Although a few partial reforms proved possible in the 1990s, for the most part, eliminating the tax benefit remained off the agenda due to instrumental power—business and the right parties avidly defended the tax benefit. However, in 2005, an unexpected opportunity for reform arose thanks to electoral competition initiated by the right on the issue of reducing inequality. In this context, vertical equity appeals compelled the right to support elimination of the tax benefit, notwithstanding the fact that the Alianza had blocked reform in the senate for one and a half decades.

### The Tax Benefit for Stock Market Investors

In 1984, the Pinochet regime created a notorious tax benefit for stock market investors. Article “57 bis” of the reformed tax code allowed anyone who purchased new-issue stocks to deduct 20% of the amount of that investment from their income tax base in perpetuity, as long as the stocks remained in the taxpayer’s possession. Article 57 bis was intended to serve as an investment incentive in the aftermath of the 1982 crisis, which had destroyed investor confidence in the stock market (Ministerio de Hacienda 2005: 92). The tax benefit was closely associated with “*capitalismo popular*,” Pinochet’s reprivatization of assets that had been nationalized during the crisis (Ffrench-Davis 2005, author’s interview).

Regardless of its original intent, this tax incentive in practice amounted to a state subsidy for upper-income investors. In effect, 57 bis guaranteed investors a positive return on new-issue stocks. For a taxpayer who had invested 1,000 UF (*unidades financieras*) (roughly 31,000 USD in 2005), the rate of return associated purely with the tax incentive, above and beyond profitability associated with the stock market, was around 9% (Figure 4.4.1). The distribution of this subsidy was extremely concentrated. In 2003, the richest centile of income-tax payers—a mere 0.5% of adults—received fully 72% of the total benefits associated with 57 bis, while the second-richest centile received 8.6% of the benefits (SII 2005: 43).<sup>1</sup>

The fiscal cost associated with 57 bis, although small in comparative terms, was nontrivial. The tax incentive cost the state an average of USD 41 million per year from 1990 to 1998, after which time the Concertación managed to restrict the use of 57 bis, and an average of USD 31 million per year from 1999 through 2005, when the incentive was finally eliminated. In total, 57 bis cost the state USD 580 million from 1990-2005.<sup>2</sup>

Moreover, while 57 bis may have served a useful purpose in the mid-1980s, no technical justifications for the regressive tax incentive remained by 1990.<sup>3</sup> Impressive economic growth, improvement and development of capital markets, and plentiful alternative options for corporate financing made the tax incentive unnecessary. In this context, instead of stimulating the stock market, the Finance Ministry pointed out that 57 bis reduced the dynamism of capital markets, given that investors could not trade their stocks if they wished to maintain the highly advantageous tax benefit (Ministerio de Hacienda 2005: 94). In the language of orthodox economic theory, 57 bis was highly inefficient and created distortions in the capital market. A Finance Ministry report accordingly condemned the “nula base teórica de apoyo a la efectividad de esta franquicia,” (Ministerio de Hacienda 2005: 94).

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<sup>1</sup>The Finance Ministry (2005: 94) reported that the top income centile received 43% of the benefits. It is likely that the Finance Ministry constructed income centiles according to the standard definition, which excludes reinvested profits, whereas the tax agency’s centiles include reinvested profits.

<sup>2</sup>Figures in 2005 dollars. Based on database compiled by Miachael Jorrat 2005.

<sup>3</sup>Essentially all Concertación economists and policymakers interviewed for this project advanced this view (see for example Ffrench-Davis 2005, Aninat 2007, Finance Ministry B 2005).



**Figure 4.4.1: Subsidies for High-Income Taxpayers Corresponding to Article 57 bis.**

Source: Ministerio de Hacienda 2005: 93.

<b>Duration of Investment (Years)</b>	<b>Average Real Yearly Return* (%)</b>
20	9.6
15	9.1
10	8.8

\*Calculated for an investment of 1,000 UF in newly emitted stocks for an individual in the top income tax bracket.

### **Business’s Instrumental Power Prevents Reform During the 1990s**

The Concertación had sought to eliminate Article 57 bis ever since it assumed power in 1990. Although the Finance Ministry repeatedly assessed possibilities for reform, business’s instrumental power for the most part precluded meaningful advances. Partial reform proved possible in 1998, but the tax benefit persisted for another seven years.

Article 57 bis was an ideological battleground with business and the right. As an UDI politician recalled: “El tema del 57 bis siempre fue polémico, tanto para la gente de gobierno como para la gente de oposición—un tema super polémico,” (Alvarez 2005, author’s interview). The Concertación viewed the tax benefit as ethically reprehensible and technically incorrect (Marfán 2005, author’s interview). However, the opposition associated the issue with property rights, a core concern. Marfán (2005, author’s interview) explained business and the right’s “visceral” resistance to eliminating 57 bis as follows:

Ellos entienden que los derechos que ellos adquirieron forman parte de su derecho a propiedad. Ellos compraron acciones entendiendo que tenían un beneficio, que el estado les prometió, de por vida. Y que después que los compraron, resulta que hay un [nuevo] autoridad que decidió que les iba a quitar el beneficio.

Business and the right accordingly defended 57 bis as an “acquired right” (*derecho adquirido*).

Because 57 bis was such a controversial issue with business and the right, the executive branch avoided pressing for reform from 1990 to 1997, while democracy was still in the process of consolidation. Business and the right were particularly strong political actors during this period thanks to Pinochet’s control over the transition process, and the Concertación had especially strong incentives to avoid provoking conflict for the sake of solidifying democracy. As Marfán (2005, author’s interview) explained:

En democracia, es muy importante no empujar la discusión hasta el punto de socavar valores y principios que son importantes para la adición al sistema de grupos importantes de la sociedad... El tema de la discusión sobre derechos de propiedad en Chile fue un tema que generó enormes rupturas políticas en la convivencia cívica. La reforma agraria de los sesenta, la socialización de empresas durante el gobierno de Allende, las privatizaciones arbitrarias en diversas rondas que hubo en el gobierno de Pinochet, eso fue siempre un tema tremendamente visceral. Estos son los temas que uno no quiere reabrir en medios de una transición a la democracia.

Motivations for avoiding conflict aside, the Concertación simply did not have the votes needed for reform in the Senate during this period, given that the right and Pinochet’s designated senators together held the majority of seats.<sup>4</sup>

<sup>4</sup>Had the Concertación managed to cobble together enough votes to eliminate the tax benefit, the opposition likely would have presented an appeal to the Supreme Court arguing that eliminating an acquired property right was unconstitutional. Although the Supreme Court would not necessarily have ruled in the opposition’s favor, the likelihood of an appeal acted as an additional disincentive for attempting reform. As PPD politician Bitar (2005, author’s interview) recalled: “Siempre nosotros sabemos que han recurrido mucho al Tribunal Constitucional en estas cosas, muchas cosas... Es una amenaza que tú tienes que enfrentarla, que si ganamos la votación en el senado donde tenemos minoría y aún así la ganas, ...hay que enfrentar al Tribunal

Instrumental power in the context of democratization as well as the relatively small fiscal cost of the tax incentive helped remove the issue of 57 bis from the Concertación's agenda during the transition period. Although eliminating the tax benefit was included in the original drafts of the 1990 tax reform, the Aylwin administration ultimately decided to drop the measure (Marcel 1997: 43, Marfán 1998: 559). As renowned PDC economist Ffrench-Davis (2005, author's interview) recalled: "había tanta oposición que [el gobierno] decía 'no vamos a hacer el esfuerzo.'" In Marfán's analysis: "era mucha pelea por poca plata;" and the administration decided to focus its efforts on the VAT and corporate tax increases, which were much more important for raising revenue.

However, Article 57 bis remained of concern to the Concertación, and some small advances were made over the course of the decade. In 1993, during the renegotiation of the 1990 tax reform (Chapter 3), the Aylwin administration secured a minor revision to the tax benefit along with preservation of the corporate tax increase (Marfán 1005, author's interview). However, 57 bis in essence remained largely unaltered.

Concertación activists, meanwhile, repeatedly called attention to the need to eliminate 57 bis. In 1995, for example, a group of Concertación senators led by PPD senator Bitar, a dedicated advocate against 57 bis, agitated for the Frei administration to include elimination of the tax benefit along with excises tax increases in the reform package designed to fund pension increases (Part 2).<sup>5</sup> The executive did not heed the request, anticipating once again that there were insufficient votes to pass the measure and reasoning that not enough revenue was at stake to make the effort worthwhile (author's interviews: Bitar 2006, Aninat 2007).

The Concertación secured a more significant but still partial modification to 57 bis as part of the anti-evasion package designed to finance additional pension increases in 1998. The reform eliminated the tax benefit for new-issue stocks acquired after 1998, but new-issue stocks purchased before the reform took effect would maintain the benefit. As long as the owners of these new-issue stocks did not sell their shares, they were entitled to the 20% deduction for life. However, as owners either sold their shares or passed away, 57 bis in practice would gradually disappear.

This partial reform succeeded in large part because it neutralized opposition arguments based on acquired property rights—it respected the "rights" of those taxpayers who had purchased shares previously.<sup>6</sup> As such, complaints based on acquired property rights were essentially absent from the debate in congress. Linking to spending and the composition of the larger reform package also helped mitigate opposition from the right. The executive offered compensations in the form of alternative incentives for investors and tax benefits for businesses investing in fixed assets.<sup>7</sup> Senator Bitar again called for the executive to eliminate 57 bis in its entirety, but without success.<sup>8</sup>

Although the 1998 reform represented an advance, it was far from a satisfactory resolution to the problem of 57 bis. Over the next seven years, 57 bis cost the state a total of USD 216 million, notwithstanding the fact that the beneficiary pool was closed to new entrants.

The Lagos administration, like its predecessors, explored possibilities for eliminating 57 bis on multiple occasions to no avail. In 2000, the Finance Ministry decided not to include the initiative in the anti-evasion reform, once again anticipating insufficient votes in the senate and avid resistance from the right (Valdes 2005, author's interview). The issue was subsequently discussed on several occasions with the business associations (Finance Ministry B 2005, author's interview). During conversations with Sofofa on the proposed Pro-Growth Initiative, the Finance Ministry raised the possibility of eliminating 57 bis in the context of legislating other initiatives that business had advocated. According to a Finance Ministry informant, business's response was a resounding rejection (Finance Ministry B 2005, author's

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Constitucional." Former designated senator and lawyer Olga Feliú also argued that eliminating 57 bis was unconstitutional (*El Mercurio*, May 28, 2005: "Alto riesgo de inconstitucionalidad pesa sobre la derogación del 57 bis").

<sup>5</sup>Diario de Sesiones del Senado, Legislatura 331, Sesión 14, July 6, 1995: 37.

<sup>6</sup>Finance Minister Aninat explicitly made this point in the Senate. (Diario de Sesiones del Senado, Legislatura 338, Sesión 15, July 21, 1998: 42)

<sup>7</sup>Mensaje de Proyecto 44-337, March 20, 1998.

<sup>8</sup>Diario de Sesiones, Legislatura 338, Sesión 13, July 7, 1998: 64.

interview). On another occasion, to silence business's continual agitations in favor of reverting to the system of taxing only distributed corporate profits, the Finance Ministry challenged the business associations to devise a proposal to compensate the associate revenue loss. Business rejected the possibility of eliminating 57 bis even in this context.

### **Opportunity for Reform: Electoral Competition from the Right on Reducing Inequality**

Despite the seemingly bleak prospects, an unexpected opportunity for reform arose in 2005 in the context of the presidential election campaign. Electoral competition on the issue of inequality initiated by the right in response to activism by the Catholic Church allowed the Lagos administration to make a remarkably effective appeal for eliminating 57 bis based on vertical equity.

In April 2005, the Church hierarchy forcefully inserted the issue of inequality into national dialog and electoral politics. At the annual Conferencia Episcopal, Chile's Catholic bishops denounced the country's high and persistent inequality:

...manifestamos nuestra preocupación por los hermanos y hermanas que sufren ...los efectos de una pobreza persistente. En nuestro país las diferencias sociales, manifestadas en calidad de vivienda, acceso a bienes de consumo, salud, educación, salario, etc., alcanzan niveles escandalosos, mientras la equidad y la globalización de la solidaridad siguen siendo un desafío que aún espera respuestas urgentes. Invitamos a incentivar los programas encaminados a superar la pobreza y a implementar caminos de mayor equidad.<sup>9</sup>

Moreover, the bishops called for each of the three presidential pre-candidates (UDI, RN and Concertación) to explain to the electorate the policies they espoused for reducing inequality. The Church in Chile had long been concerned with inequality as well as poverty, but the advent of a more progressive bishop to the presidency of the Conferencia Episcopal paved the way for prioritization of those issues.<sup>10</sup> The 2005 declaration was much stronger than the Church's previous commentaries on inequality, and it received broader coverage in the press (Ffrench-Davis 2005, author's interview). All of Chile's major newspapers reported the bishops' declaration.<sup>11</sup> Consequently, as Ffrench-Davis (2005, author's interview) recalled, the declaration "creó mucha comoción. ...Y fue una unanimidad de todos los obispos chilenos—eso es un escándalo. No puede ser."

Lavín's campaign team perceived that the bishops' high-profile concern over inequality presented an opportunity to attack the highly-popular Lagos administration on an issue that was central to the Concertación's agenda. Lavín quickly announced his support for the bishops and attempted to claim the banner of reducing inequality as his own: "los obispos tienen razón, los pobres siguen esperando... y eso es lo que hay que cambiar profundamente."<sup>12</sup> Moreover, he sought to blame the Concertación for Chile's persistent inequality and poverty: "después de 16 años de gobiernos de la Concertación, hay un millón y medio de chilenos que viven hacinados, 190 mil personas que viven con 37 mil pesos al mes y otros 6 millones de chilenos que viven con menos de 2 mil 500 pesos al día."<sup>13</sup>

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<sup>9</sup>Los Obispos de la Conferencia Episcopal de Chile, Punta de Tralca, March 22, 2005. <http://documentos.iglesia.cl> One of the bishops quoted in the press reasserted this message: "uno de los temas valóricos fundamentales para nosotros es el de la injusticia y el modelo económico como el que vivimos actualmente. El tema de la pobreza, la clase media que se va empobreciendo, la redistribución del ingreso, que es uno de los peores... esos son los que interesa tartar," (*La Segunda*, March 26, 2005: "Obispos reprochan 'niveles escandalosos' en las diferencias sociales").

<sup>10</sup>Paula Guerra, "Desigualdad: la papa caliente" in *La Nación*, May 8, 2005. Church authorities had made similar statements during the previous year. For example, Cardinal Errázuriz declared in a homily for the *Fiestas Patrias*: "Luchemos con más intensidad y con más prontitud contra la inequidad, la injusticia y la intolerancia, acortemos de verdad la brecha entre los ingresos más altos y los más bajos, busquemos mejores condiciones para que aumenten las fuentes de trabajo," (Prensa CECH, Sept. 18, 2004: "Obispos invitan a dialogar en camino al Bicentenario").

<sup>11</sup>*La Tercera*, April 27, 2005: "Iglesia pide que los votantes se informen," *La Segunda*, April 26, 2005: "Obispos reprochan 'niveles escandalosos' en las diferencias sociales," *El Mercurio*, May 5, 2005: "Obispos de Chile," *La Nación*, April 27, 2005: "Lavín utiliza declaración de los obispos," *El Sur*, April 27, 2005: "Los obispos solicitan atender la desigualdad."

<sup>12</sup>Quoted in *La Tercera*, March 27, 2005: "Iglesia pide que los votantes se informen."

<sup>13</sup>Quoted in *La Nación*, April 27, 2005: "Lavín utiliza declaración de los obispos."

Although Lavín's statements appear dichotomously at odds with the much of the right's policy record, particularly on economic policy and taxation, the rhetoric was not new. The UDI, which had built a popular base through control of mayoralties and small-scale, local-level clientelism (Luna 2005), had long proclaimed its interest in reducing poverty. Concern over inequality, however, was a newer development that appears to have emerged in response to the Concertación's repeated electoral success and emphasis on the issue. For example, the right denounced the 2003 VAT increase as regressive and inconsistent with the Lagos administration's equity agenda in an effort to inflict political damage on the governing coalition (Chapter 4, Part 2). Likewise, Lavín made inequality of opportunity a central theme in his presentation at the prestigious annual business conference, ENADE, in 2004.<sup>14</sup> This emphasis can be understood partly as an effort to strengthen the UDI's popular support base. By the end of 2004, the need to reduce inequality—not just poverty—had achieved the status of political consensus, at least at the level of rhetoric. All of the major parties and their associated think tanks acknowledged that trickle-down economics was not sufficient.<sup>15</sup>

During the weeks following the bishops' statement, inequality became the central issue in the presidential campaign. The Lagos administration defended its own record and reminded the citizenry of the right's long history of blocking redistributive reforms in Congress and Pinochet's responsibility for the high levels of inequality that the democracy inherited.<sup>16</sup> The Finance Minister called particular attention to the right's resistance to the 2000 Anti-Evasion reform, designed to fund expanded social spending.<sup>17</sup> Meanwhile, Lavín persisted in his attempt to blame the Concertación for what he asserted was the Lagos's failure to deliver on the promise of "growth with equity." "La desigualdad, Presidente, continua," Lavín retorted in the press, "Hay un Chile que crece, pero es para unos pocos y a la gran mayoría no le ha tocado todavía."<sup>18</sup>

The debate on inequality culminated in a carefully crafted challenge from the Lagos administration: that Lavín and the right finally concede to eliminating the highly regressive Article 57 bis: "El artículo famoso, 57 bis, todavía está vigente y significa un tremendo apoyo a la desigualdad... en lugar de hablar tanto, ¿qué tal si mañana mandamos un proyecto de ley y en menos de 24 horas se aprueba derogar el 57 bis?"<sup>19</sup> 57 bis was the perfect issue for this political moment. As Marcel (2005, author's interview) recalled: "se buscó lo más obvio, lo que más le podía doler a la derecha, por lo que se había opuesto en el pasado, y bueno, ellos tuvieron que contribuir a aprobarlo." Similarly, another Finance Ministry informant observed: "[57 bis] era un mecanismo que claramente no tenía cómo generar ningún impacto en eficiencia, ninguno. Era una pura transferencia de recursos hacia personas ricas. No había cómo argumentar distinto. Entonces era políticamente nítido. La oposición de la derecha a reformar esto no era posible, después de haber planteado todo este argumento de la desigualdad," (Finance Ministry B 2005, author's interview).

Accordingly, vertical equity formed the central basis for the reform. The text of the proposal, sent to Congress later that week, both extolled the new consensus on reducing inequality and noted the right's historic aversion to the issue: "Afortunadamente hoy ha surgido un consenso político y social respecto a la urgencia de abordar el desafío de mejorar la distribución del ingreso, consenso al cual se han sumado sectores que tradicionalmente evadían el tema."<sup>20</sup>

While the tax-side vertical-equity appeal was the main reform strategy, the administration also linked the revenue to social spending, making the reform progressive on the spending-side as well. The revenue saved by eliminating 57 bis would fund 15,000 new scholarships for low-income university

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<sup>14</sup>*El Mercurio*, Jan. 11, 2005: "¡Ojo, Joaquín!" Lavín had also talked about inequality of opportunities in his 1999 campaign platform.

<sup>15</sup>*El Mercurio*, Jan. 4, 2005: "Temas pendientes en último año de Lagos," *El Mercurio*, May 10, 2005: "Think Tanks."

<sup>16</sup>*El Mercurio*, May 6, 2005: "Lagos responde críticas de Lavín," *El Mercurio* May 11, 2005: "Gobierno no afloja en disputa con Lavín."

<sup>17</sup>*El Mercurio*, May 6, 2005: "Lagos responde críticas de Lavín."

<sup>18</sup>Quoted in *El Mercurio*, May 7, 2005: "Presidente, deje que Soledad y Michelle se defiendan solas."

<sup>19</sup>Lagos quoted in *El Mercurio*, May 10, 2005: "Lagos reta a Alianza a derogar exención tributaria en 24 horas."

<sup>20</sup>Mensaje de Proyecto 494-352, May 13, 2005: 2.

students. The proposal text pointed out the importance of educational opportunities for socio-economic mobility.<sup>21</sup>

In the context of competition from the right over the issue of inequality, the vertical equity appeal was extremely effective. Lavín had no choice but to accept Lagos' challenge to eliminate the tax benefit, and he did so with enthusiasm: "Sería fantástico, estamos todos con la igualdad. Hagámoslo."<sup>22</sup> Once Lavín accepted the challenge, the right was compelled to follow his lead in Congress. Despite their longstanding defense of 57 bis and the fact that most of the opposition still maintained that the tax benefit was an acquired property right protected by the Constitution (Alvarez 2005, author's interview), the reform received unanimous approval in the lower house and nearly unanimous approval in the Senate.<sup>23</sup> Two lone designated senators voted against the proposal.<sup>24</sup>

Electoral concerns clearly motivated the right to accept the reform. As an UDI politician candidly remarked: "la oposición demostró que esta vez iba a aceptar cosas que habitualmente no estaba dispuesto a aceptar con tal de que no afectaran la opción presidencial" (Alvarez 2005, author's interview). First, Lavín's credibility was at stake. If the legislators had not followed Lavín's lead, the Concertación would have enjoyed a double political victory, demonstrating that the right in fact was the main obstacle to enhancing equity in Chile, and that Lavín could not command authority over the oft-divided right coalition (RN and UDI) and hence would not be able to effectively govern the country. Second, lessons taken from a similar episode during the 1999 presidential campaign convinced the right that the electoral cost to voting against the reform, given the new political salience of inequality, could be devastating. In 1999, the Frei administration sent a controversial labor reform bill to Congress in the midst of the Lavín-Lagos campaign. The right later interpreted its opposition to expanding labor rights as the factor that cost it the election.<sup>25</sup> The 1999 episode weighed heavily in the right's political analysis, as reported in the press:

En 1999, se usó la reforma laboral, que según la Alianza hizo que Lavín perdiera por unos 30 mil votos la presidencial frente a Ricardo Lagos, y después el royalty, cuya discusión puso en el Congreso dos meses antes de las municipales de octubre pasado. La centroderecha no está dispuesta a repetir la trampa del 99, dice un cercano a Lavín.<sup>26</sup>

### **The Limits to Equity-Enhancing Reform in 2005**

Vertical equity appeals in the context of competition from the right over reducing inequality had finally allowed the Concertación to eliminate 57 bis, after 16 years. The reform was a clear victory for the Concertación. Remarkably, however, the Lagos administration refrained from testing the scope of this rare political opportunity. Despite enthusiasm within the Concertación regarding the possibility of challenging the right to accept additional redistributive reform proposals, the administration proposed no further initiatives. Once again, business's strong instrumental power helped to restrict the executive's agenda.

Following the elimination of 57 bis, Lavín asserted in the press that he and the Alianza were prepared for additional challenges from the Lagos administration with regard to advancing pro-equity reforms.<sup>27</sup> This statement stimulated significant excitement within the Concertación. Socialist Party legislators agitated for the executive to propose elimination of other regressive tax benefits. Additional suggestions from within the ranks of the Concertación and among the president's own circle of advisors (Finance Ministry B 2005, author's interview), included reforms related to the pension system and

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<sup>21</sup>Mensaje de Proyecto 494-352, May 13, 2005: 4.

<sup>22</sup>Quoted in *El Mercurio*, May 11, 2005: "Gobierno no afloja en disputa con Lavín."

<sup>23</sup>Six opposition senators did not attend the session.

<sup>24</sup>Diario de Sesiones, Legislatura 353, Sesión 5, June 14, 2005: 69.

<sup>25</sup>*El Mercurio*, May 12, 2005: "Joaquín Lavín y las fórmulas para enfrentar la desigualdad," *El Mercurio*, May 13, 2005: "Nuevo Escenario de Campaña."

<sup>26</sup>*El Mercurio*, May 13, 2005: "Nuevo Escenario de Campaña."

<sup>27</sup>*El Mercurio*, May 12, 2005: "Joaquín Lavín y las fórmulas para enfrentar la desigualdad."

educational subsidies.<sup>28</sup> Increasing the corporate tax was even considered at the highest levels (Chapter 3). A number of informants felt that the administration lost a significant opportunity for further reform by refraining from issuing another equity challenge (author's interviews: Montes 2005, Bitar 2006, Ffrench-Davis 2005).

Many considerations contributed to the Lagos administration's decision not to pursue further reforms, but two central factors emerged from interviews with executive branch informants. First, the conviction that linking to spending was critical for tax reform discouraged the administration from initiating further tax proposals (author's interviews: Eyzaguirre 2007, Lagos 2006). Inside informants asserted that Lagos' programs already had permanent funding sources (author's interviews: Finance Ministry B 2005, Executive Advisor A 2005). And the administration was not prepared to design new social programs six months before leaving office or to unofficially earmark additional funding for existing programs (in the form of a political promise that a Concertación successor would be obliged to honor). Informants asserted that so-doing would inappropriately wrest initiative from Bachelet, the anticipated electoral victor, who had the prerogative to establish her own social agenda priorities (author's interviews: Finance Ministry B 2005, Eyzaguirre 2007).<sup>29</sup> Given the prevailing discursive consensus in favor of reducing inequality and the potential to legitimate additional tax increases on the basis of vertical equity, it seems surprising that executive officials felt links to spending were so critical to reform. However, this position was pervasive among Lagos administration informants. For example, a Finance Ministry advisor asserted:

Si uno quería avanzar más y además en cosas que generan mayor cantidades de recursos, simultáneamente tiene que decir en que va a usar estos recursos. O por lo menos en Chile es la economía política: que tu no puedes aumentar impuestos—o reducir franquicias—sin decir en qué va a usar la plata. (Finance Ministry B 2005, author's interview)

It is quite possible that the right would have attacked even an equity-enhancing tax reform as irresponsible, despite the electoral salience of inequality, were a funding need not specified. This episode thus further establishes the fact that Concertación administrations view links to spending as a necessary, if not sufficient, strategy for reform (Chapter 4, Part 2).

Second, the Lagos administration's reluctance to take on another major battle with business and the right after the tax on copper mining, which had entailed major conflict (Chapter 4, Part 3), weighed against pursuing additional tax reforms or redistributive reforms more generally (author's interviews: Marcel 2006, Finance Ministry A, B 2005, Burgos 2005). As one Finance Ministry informant recalled: "consideró que ya tenía conflictos en muchos frentes, ... fue un análisis general, de cuantos conflictos estoy enfrentando, cuántos soy capaz de confrontar, al mismo tiempo en una época de elecciones, y consideró que quizás no era el momento para agregar otro área de batalla," (Finance Ministry A 2005, author's interview). Although business associations were relatively silent in 2005 on the issue of 57 bis, the reform was certainly not viewed favorably. Various complaints about the reform issued at a SOFOFA meeting found their way into the press.<sup>30</sup> In the assessment of one Concertación legislator: "la experiencia del 57 bis, ... el gobierno quedo como asombrado, porque le generó mucho ruido, mucho conflicto, mucha recriminación de parte del sector empresarial," (Montes 2005, author's interview). Lagos (2007, author's interview) recalled eliminating 57 bis as one of the reforms that business had fought hardest against during his tenure in office and added "cuando lo aprobó el Congreso, seguían en contra, el sector empresarial." Moreover, the administration did not want Bachelet to inherit unresolved

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<sup>28</sup>*El Mercurio*, May 13, 2005: "Nuevo Escenario de Campaña."

<sup>29</sup>For example, the former Finance Minister asserted: "We did entertain the idea of doing something, but at the end of the day, we decided it was not appropriate for a government that was leaving ..., and this was up to Michelle Bachelet, whether she was going to do something else," (Eyzaguirre 2007, author's interview).

<sup>30</sup>"En el consejo general de la Sofofa, celebrado esta semana, la propuesta fue 'el' tema. Incluso, algunos industriales la tacharon de 'peligrosa,' 'populista' y de 'burla a la fe pública,'" (*El Mercurio*, May 28, 2005: "Alto riesgo de inconstitucionalidad pesa sobre la derogación del 57 bis."

conflicts with business and the right initiated during the final months of Lagos' term (Finance Ministry B 2005, author's interview).

### **Impetus for Future Reform**

Although the Lagos administration did not pursue further reform, eliminating 57 bis helped to build political momentum for revoking other regressive and technically unjustified tax benefits. Spurred by the 2005 reform, the Finance Ministry included a chapter on the problems associated with tax benefits and tax exemptions in the *Exposición de la Hacienda Pública* (Finance Ministry 2005: 74-96) presented in the fall of 2005, which clearly established a precedent for future reforms. The Concertación had long sought to broaden tax bases and close loopholes, but eliminating 57 bis gave the coalition more experience in managing this issue politically. As a Finance Ministry informant observed: "como temas que quedan pendiente: son a lo mejor hacer una limpieza mayor de exenciones. Pero eso la verdad es que nunca tuvimos verdadero diagnostico y todo bien hecho como para hacerlo hasta ahora. ...creo que... logramos una cierta manera de mirar," (Finance Ministry B 2005, author's interview). Eliminating unjustified tax benefits was explicitly included in Bachelet's program of government as a way to generate additional funds for social spending. Finally, eliminating 57 bis gave renewed impetus to Concertación legislators' campaign against the special VAT benefit for construction of homes, an issue that was finally taken up by the Bachelet administration in 2008.

## Part 5. Restricting a Regressive VAT Credit for Construction of Homes

In 2008, the Concertación restricted the use of a highly regressive and costly VAT credit for the construction of houses in order to end what amounted to a subsidy for the construction sector and upper-income consumers. Although Concertación economists agreed that this tax benefit should be eliminated, reform had remained off of the agenda from 2000 through 2007, primarily due to the construction sector's instrumental power, but on occasion because of concerns regarding structural power as well. However, activism by a group of committed Concertación legislators paved the way for the executive to initiate incremental reform in 2008, when a propitious opportunity arose to include the measure in a broader reform package that provided popular benefits and inducements for the right.

The 2008 reform illustrates both the possibilities and the limitations of tax-side and benefit-side strategies. On the one hand, targeting elites and linking tax increases to popular benefits made the reform politically viable in a context of intense opposition from the construction sector and the right, as well as some sectors within the governing coalition, and helped to contain conflict on what had proven to be an extremely controversial issue. On the other hand, despite the reform's highly strategic design, the executive was forced to make concessions that significantly curtailed the revenue-saving potential of the VAT modification, leaving the cost of the other benefits included in the reform package uncompensated.

### The Special VAT Regime for Construction of Homes

In 1987, the Pinochet dictatorship incorporated real estate into the VAT regime and established a special tax benefit for the construction of homes. Prior to this reform, construction firms' VAT credits—that is, their VAT payments on inputs—constituted a pure cost, since homes were not subject to the tax, and the firms therefore could not deduct their VAT credits from VAT “debits”—the tax that in other cases was collected from the final consumer. Consequently, construction firms had strong incentives to evade paying the VAT on their inputs. To address this problem without causing housing prices for consumers to increase substantially, real estate was included in the VAT, but the construction firms were allowed to deduct from their tax obligations an amount equivalent to 65% of the VAT debits they collected. On the one hand, inclusion in the VAT regime reduced firms' incentives to evade VAT payments on inputs, because they could now pass that cost on to the final consumer. On the other hand, housing prices would not be unduly affected, because the tax benefit for the firms was designed so that they would pass on *only* the cost of their VAT payments on inputs to consumers, which represented approximately 35% of the value of homes according to cost structure studies of that era. In practice then, the state collected from home buyers the VAT obligations that construction firms had previously owed but evaded on their input purchases, and the firms effectively paid no net value-added tax (Ministerio de Hacienda 2005: 89, SII 2005: 83; authors interviews: Finance Ministry A 2005, Echeverría 2008).<sup>1</sup>

However, this special VAT regime for construction proved highly problematic in terms of equity. First, the VAT benefit disproportionately favored upper-income consumers. In practice, the VAT regime subsidized the purchase of expensive homes as well as low-income homes, and multiple residences as well as first abodes. Consequently, the special VAT regime was highly regressive: 70% of the benefits accrued to individuals in the top 20% of the income distribution (SII 2005: 44). Finance Ministry technocrats denounced that this distribution was even less equitable than the overall distribution of household income in Chile (Finance Ministry F 2008, author's interview). Second, many economists argued that contrary to the construction sector's assertions that the benefits were transmitted entirely to consumers through lower prices, the VAT regime directly inflated the firms' profits (author's interviews: Agostini 2005, Finance Ministry A 2005).<sup>2</sup> Continual subsidization of the construction sector was

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<sup>1</sup>Of course, cost structures changed over time, such that the firms may not have remained entirely exempt from net value-added tax payments by the late 2000s (Finance Ministry A 2005, author's interview).

<sup>2</sup>Both of these informants made “revealed preferences” arguments in favor of this point, in addition to noting that the specifics of supply and demand determine what percentage of the tax can be passed on to consumers. Agostini (2005, author's interview) observed: “If they were able to actually raise the prices as much as they are saying, then it shouldn't matter to them. Why are you complaining? If I take away this exemption, and the only thing that's going to happen is that you increase your price for the full



particularly questionable during conditions of high growth and profitability, such as prevailed between 2002 and 2006. Moreover, the VAT benefit was just one of multiple subsidies for the construction sector, which received approximately 568 million dollars of tax benefits in 2006 (0.5% GDP) (SII 2005: 12).

The price tag accompanying the special VAT regime for construction was impressive: it cost the government on average 313 million dollars (2008 USD) per year. In 2004, the cost amounted to fully 0.3% of GDP, making the VAT benefit Chile's third largest tax expenditure.<sup>3</sup> Socialist legislators asserted that this annual revenue loss was more than double the deficit of the botched Santiago public transportation system overhaul in 2008, and equivalent to the entirety of subsidies provided by the Ministry of Housing for low-income families.<sup>4</sup> The accumulated cost of the special VAT regime from 1990 to 2008 reached almost 6,000 million dollars (Ministerio de Hacienda 2008: 1).

Aside from its tremendous cost and regressivity, Concertación economists agreed that the VAT benefit for construction was technically unjustified from the point of view of liberal economic theory (Agostini 2005, author's interview). While the construction sector and economists associated with the Chicago School argued that homes should be exempt from the VAT because they represent an investment rather than consumption (Hurtado 2008, author's interview),<sup>5</sup> Concertación economists countered that uniform application of that logic would completely denature the VAT: "if you follow their argument, then we should put those same exemptions on computers, on any durable good—cars, everything," (Agostini 2005, author's interview). Lagos' Finance Minister in fact devoted a special section in the *Exposición de la Hacienda Pública* (Ministerio de Hacienda 2005: 74-96) to explaining the need to eliminate the VAT benefit and other tax exemptions. Past and present Finance Ministry informants agreed that the VAT benefit should be either eliminated or substantially restricted (author's interviews: Marcel 2005, Finance Ministry B 2005, Finance Ministry D 2005, Finance Ministry F 2007, Finance Ministry E 2008, Foxley 2005, Aninat 2007).

### **Business Power and Internal Divisions Keep Reform Off the Agenda, 2000-2007**

Despite the technical consensus in favor of eliminating the VAT benefit for construction, and despite significant pressure to do so from Concertación legislators, the reform remained off of the Lagos administration's agenda and was not taken up by the Bachelet administration until 2008. The construction sector's instrumental power and the related problem of obtaining sufficient votes in Congress were the primary factors that discouraged the executive from addressing this issue, although structural power was relevant during certain periods as well.

### ***The Construction Sector's Strong Instrumental Power***

The construction sector enjoyed especially strong instrumental power in the congressional arena based on relationships with legislators. Along with the partisan linkages to right parties enjoyed by business more broadly, anecdotal evidence suggests that informal connections may have linked the construction sector not only to *Alianza* members, but also to several important legislators from the Christian Democratic party whose votes were critical to passing the government's reform proposals (Montes 2008, author's interview).<sup>6</sup>

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amount of the exemption you are losing, then nothing happens to you. So actually the fact that they are complaining so much... it's a contradiccion in their own argument." Similarly, the Finance Ministry informant asserted: "no puede traspasar todo. Porque obviamente tiene que haber algunas ajustes de oferta y demanda... no les importaría tanto si fueron capaces de traspasar todo al consumidor."

<sup>3</sup>The deferment for taxes on reinvested profits and the tax deferment for income invested in pension funds represented larger expenditures (SII 2005).

<sup>4</sup>Montes, Cámara de Diputados, Legislatura 356, Sesión 9, March 20, 2008: 17.

<sup>5</sup>Patricio Muñoz, President, Asociación de Desarrolladores Inmobiliarios Asociación Gremial, in Acta, Sesión 245a 2005: 4.

<sup>6</sup>"Las acciones y sociedades que los senadores no declararon," <http://ciperchile.cl>, Oct. 3, 2008; Diario de Sesiones del Senado, Legislatura 356, Sesión 4a, March 19, 2008: 131; *Estrategia* March 20, 2008: "Gobierno Cedió en Límite a Franquicia en Construcción Para Salvar Proyecto."

The construction sector also enjoyed various resourced-based sources of instrumental power that enhanced its ability to conduct effective lobbying campaigns. A strong peak association, the *Cámara Chilena de Construcción* (CChC), fostered sectoral cohesion, and the CChC was an important member of the CPC, which helped foster cross-sectoral cohesion. The construction sector also enjoyed abundant financial resources. Anecdotal evidence suggests that construction businesses made sizable campaign donations across party lines (Montes 2005, author's interview). The construction sector also enjoyed significant technical expertise. The CChC's studies department is reputed to be one of the best among Chile's business associations, and it has enjoyed the prestige of association with well-known Chilean economists including Felipe Morandé.<sup>7</sup> Although they did not share the CChC's technical assessment of the VAT benefit, past and former Finance Ministry informants recognized the CChC as among the most powerful of Chile's business associations (author's interviews: Aninat 2007, Marcel 2007, Finance Ministry F 2008), an assessment shared by a range of other observers.<sup>8</sup>

Furthermore, the construction sector's influence in Congress on the VAT issue was enhanced by its ability to exploit an interest in protecting the "middle classes," not only among the right parties but also within the ranks of the Christian Democrats. The PDC and the UDI in particular were competing to attract votes from middle-class consumers (Navarette 2005: 129),<sup>9</sup> and the PDC viewed middle-class sectors as a "natural enclave of support" (Boeninger 2005: 25). Because housing was perceived as a critical issue for members of the "middle classes," the construction sector had significant potential for winning over votes from the governing coalition by arguing that eliminating the benefit would significantly increase the prices of homes purchased by these sectors.<sup>10</sup>

### ***The Construction Sector's Occasional Structural Power***

In addition to instrumental power, structural power played a role in keeping reform off the agenda during periods of slow growth or recession. The construction sector accounted for about 8.5% of GDP in 2008 (Finance Ministry F 2008, author's interview) and was recognized as critical for providing jobs and stimulating growth in times of recession. Former Finance Minister Aninat (2007, author's interview), for example, asserted that investment in the construction sector and housing in particular helped Chile emerge from the recession produced by the East Asian crisis. Lagos (2006, author's interview) explicitly stated his concern that the VAT reform should be timed carefully to avoid a negative economic impact:

Tiene que medirse en qué momento que lo envías, para que no afecte ...los niveles de inversión. Eso es un desincentivo a la inversión en construcción. ...estoy de acuerdo con que eso se debe derrogar, ...pero me parece que hay que buscar el momento para derrogarlo para que no afecte a una económica que esta comenzando a retomar el crecimiento.

Similar concerns may also have discouraged Bachelet's Finance Minister from initiating the reform in 2006 or 2007, when growth rates proved disappointing (author's interviews: Montes 2008, Escalona 2008).

Finance Ministry informants from the Bachelet administration were also concerned that the construction sectors' assertions that eliminating the tax benefit would have negative effects on growth and employment could influence some Concertación legislators: "la construcción paga mucho empleo, y por

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<sup>7</sup>*La Nación*, March 24, 2008.

<sup>8</sup>For example, Patricio Herman of the NGO *Defendamos la Ciudad*, who was invited to the Senate Finance Committee meeting on the VAT benefit, referred to the CChC as "el gremio empresarial más influyente, después de la Sofofa, y el poder fáctico más poderoso que hay en el país." *La Nación*, March 23, 2008: "Constructores con trajes a la medida: Cómo la Cámara de la Construcción cuida sus intereses."

<sup>9</sup>As the future Finance Minister commented during the presidential campaign: "The PDC and Lavín are trying to find their niche, and they sense there is a political niche within this disgruntled middle class... a sort of over-indebted middle class consumer, who has five credit cards and who is juggling them all. That's a big issue in this country," (A. Velasco 2005, author's interview).

<sup>10</sup>Note that other business sectors did not share this strategic advantage. The mining sector, for example, could not take advantage of legislators' interests in protecting the middle classes in the case of the royalty, which would have had no direct impact on Chilean consumers (although SONAMI made some headway by arguing that Chilean-owned mines should be considered small businesses).

la vía de los empleos que la construcción genera y la amenaza de que esto va a reducir empleo también afecta a distintos sectores, no solamente de la Alianza sino también a lo mejor algunos de la Concertación,” (Finance Ministry F 2007, author’s interview). Therefore, even if the executive did not perceive a credible withholding threat in response to eliminating or reducing the tax benefit, legislators’ perceptions of the construction sector’s structural power could make the initiative even harder to pass.

### ***Restricting the Agenda***

Given the construction sector’s strong instrumental power and the occasional salience of structural power, executives avoided the issue of the special VAT regime. Concertación legislators and Finance Ministry informants confirmed that the Lagos administration did not wish to undertake the reform because it was viewed as politically unviable and was expected to entail significant levels of conflict (author’s interviews: Eyzaguirre 2007, Finance Ministry B 2005, Foxley 2005, Montes 2005). Similarly, a Finance Ministry informant from the Bachelet administration recalled: “Iba a ser un pelea difícil. Preguntar en qué momento, y en qué contexto, a cambio de qué. Pero siempre se supo que iba a ser una pelea difícil,” (Finance Ministry F 2008, author’s interview).

Even in the context of accelerated growth during 2005 (around 6%), which made it highly improbable that restricting the VAT benefit would have more than a trivial affect on the economy, and electoral competition on the issue of improving equity, which had made possible elimination of the tax subsidy for holders of first-emission stocks (57 bis) in May of that year, the executive declined to initiate reform. As discussed in Chapter 4, Part 4, the administration did not wish to take on another major battle with business and the right after passing the tax on copper mining, despite the success with 57 bis. In addition, the administration anticipated that maintaining internal discipline on the VAT reform would be a difficult challenge (author’s interviews: Executive Advisor A 2005, Bitar 2006), given the PDC’s interest in defending middle class sectors and sensitivities to structural power arguments.<sup>11</sup>

The Bachelet administration, meanwhile, faced additional disincentives beyond business power for initiating VAT reform, and tax increases more generally, as discussed in Chapter 3. Most importantly, the context of abundant revenue from the dramatic increase in copper prices lowered the priority of tax increases. As a Finance Ministry informant recalled: “el tema fue cómo discutir el exceso de recursos que había. ...la prioridad estaba en gastar bien lo que había más que entrar en una discusión o una pelea para ver cómo recaudar más,” (Finance Ministry F 2007, author’s interview). In addition, the Bachelet administration faced greater challenges from within the Concertación’s own ranks in Congress than the Lagos administration. The Concertación’s majority in the Senate had become patently unreliable by 2007. And Bachelet was in a weaker position to enforce discipline, in part because of her initial attempts to distance her administration from the party structure. This weakness would be particularly problematic for a reform that could be expected to raise objections within the PDC.

### **Parliamentary Activism: Laying the Groundwork for Reform**

As in the case of the copper royalty, activism by Concertación legislators played an important role in creating more favorable conditions for reform and in pressuring the executive to move forward with the initiative, although this goal was not achieved until 2008.

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<sup>11</sup>Moreover, Lagos’s comments in a 2006 interview with the author suggested that he was concerned that sending a VAT reform to Congress in 2005 could have incited the construction sector to attempt a capital strike, involving politically-coordinated disinvestment, notwithstanding market incentives to continue normal activity, in order to influence the elections in favor of the right: “estábamos en medio de la campaña, y yo no quise introducir mas ruidos respecto de eso porque no lo habíamos planteado con mucha anticipación. Y no queríamos que usara esto como una excusa para disminuir la inversión de la construcción privada,” (emphasis added). Market-coordinated disinvestment in response to reform was highly unlikely at this time, given the excellent market conditions that prevailed and the positive attitudes expressed by businessmen regarding the economy and the policies of the Lagos administration in 2005 (*El Mercurio*, Nov. 30, 2005: “El tipo de cambio, el modelo económico y los impuestos marcaron la agenda de Enade 2005,” *El Siete*, Nov. 30, 2005: “Lagos selló con un balance de logros y desafíos su alianza con empresarios”).

A core group of Concertación legislators led by Socialist Deputy Carlos Montes began to work on the issue of the VAT benefit as early as 2000 (Montes 2005, author's interview).<sup>12</sup> When the Finance Minister repeatedly turned down their requests to send a reform proposal to Congress, the legislators found a loophole that allowed them to sidestep the requirement of executive initiative on tax reform: they proposed to alter the definition of homes in the existing law such that the VAT benefit would apply only to the construction of low-income housing.<sup>13</sup> Although the constitutionality of the initiative was still questionable, the proposal allowed the legislators to draw attention to the issue of the VAT benefit and to initiate discussions within the Concertación and with the opposition on a politically acceptable formula for limiting its cost and rectifying its distributional inequities.

In the face of a major lobbying effort by the CChC, and without active support from the executive, the legislators' bill was destined for failure. It was defeated on the floor of the Chamber of Deputies in 2005, with 35 votes in favor and 57 against. The initiative did not receive unanimous support within the Concertación—eight PPD deputies, four PDC deputies, and one socialist voted against it.<sup>14</sup> Legislators who supported the reform were not surprised by this outcome:

Quando en materias impositivas el gobierno no clarifica y no disciplina, es bien probable que pase lo que pasó, en que los parlamentarios actúen más libremente en tiempos de campaña parlamentarios, [los] que tienen vinculaciones al mundo de la construcción se vieron complicados... la razón de la indisciplina fue que el gobierno levantó las manos... (Burgos 2005, author's interview)

Various legislators attested to the intensity of the CChC lobby, remarking on the continual presence of its representatives in the Congress and frequent phone calls from association leaders. In the words of Montes (2005, author's interview): "más que lobby, fue presión indebida." An academic economist who followed the process closely made similar observations: "Its impressive to me that [despite] this general agreement among economists, and a large group in congress, the construction sector managed to do enough lobbying that the reform got rejected," (Agostini 2005, author's interview).

Despite the failure of the bill, however, the legislators' efforts helped to initiate a broader debate about the special VAT regime for construction. The Finance Ministry toward the end of 2005 publicly expressed the conviction that this tax benefit should be eliminated. More importantly, Bachelet implicitly incorporated the issue into her program of government, which served as her campaign manifesto:

...se enmarcará un ejercicio de evaluación de la eficiencia y efectividad de las exenciones tributarias que actualmente contempla nuestra legislación. Reemplazaremos aquellas que no sean efectivas...por instrumentos alternativos. ...los requerimientos específicos de financiamiento de una reforma tan urgente como la reforma provisional, y la necesidad de compensar las pérdidas de ingresos tributarios por los eventuales tratados de libre comercio con China e India, necesitarán medidas tributarias específicas. Concentraremos estas medidas en la reducción de la evasión y la elusión, en la revisión de exenciones injustificadas y en un mayor aporte de los sectores de mayores ingresos. (Bachelet: Programa de Gobierno, 2005: 38)

The VAT benefit, which was among the most costly of Chile's tax expenditures, was clearly among the "unjustified exemptions" to be revised. This statement was in fact interpreted by many Concertación legislators as a campaign promise to address the VAT issue.

The Concertación legislators continued to push for reform once Bachelet was elected. Finance Minister Velasco repeatedly declined to initiate the reform, although he had directed the formulation of

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<sup>12</sup>Sesión 245a de la Comisión de Hacienda, Cámara de Diputados, July 19, 2005.

<sup>13</sup>"Para los efectos de este artículo, se entenderá por 'habitación,' toda construcción destinada a dicho fin, cuyo valor de tasación no sea superior a 520 Unidades de Fomento," (Proyecto de Ley: "Precisa sentido y alcance del término habitación, en el inciso tercero del artículo 21 del decreto ley N° 910, de 1975," Boletín 3737-14, Dec. 14, 2004: 5.

<sup>14</sup>Cámara de Diputados, Legislatura 252, Ordinaria, Sesión 30, Aug. 16, 2005.

Bachelet's program of government during the campaign.<sup>15</sup> Legislators therefore initiated a second version of their 2005 proposal. This time, they doubled the limit previously proposed on the value of homes that would remain eligible for the VAT benefit. Subsequent negotiations doubled the cutoff value once again, to 2000 UF (roughly USD 84,000 in 2008).<sup>16</sup> These modifications secured unanimous support from the Concertación deputies, and the initiative was approved in the lower house in January of 2008.

The efforts of Montes and his supporters finally paid off in March of 2008, when the administration initiated a reform that closely resembled the legislators' proposal. But while pressure from the Concertación legislators provided the groundwork and the extra impetus the executive needed to initiate reform of the VAT regime for construction, strategic timing was critical. In fact, the Finance Ministry had been patiently waiting for an opportune moment to present the reform.

### **The 2008 Reform: Linking to Popular Benefits and Vertical Equity Appeals**

In the context of comparatively slow growth, concerns over inflation, increasing energy costs, and depreciation of the peso relative to the dollar, the Finance Ministry proposed a reactivation package consisting of a temporary gas tax reduction, elimination of the stamp tax (a financial transactions tax) for small businesses, and advancement of a stamp tax rate reduction legislated in 2006 originally scheduled to take effect in 2009. To compensate the revenue loss associated with these measures, the VAT benefit for construction would be eliminated for high-valued homes.

The design of the reform package was highly strategic. First, the VAT benefit restriction was linked to benefits (in the form of tax cuts) that were not only electorally attractive for legislators across party lines, but also inherently appealing to business and the right. Second, the impact of the VAT benefit restriction was targeted at upper-income groups, which allowed the executive to make appeals on the basis of vertical equity.

The reform package included both universal and targeted tax cuts that elicited active support from legislators and the business sector. The two-year reduction of the gas tax benefited middle and upper income consumers—partially compensating the affect of restricting the VAT benefit—as well as businesses, whose profit margins had been squeezed by increasing energy prices (Muga 2008, author's interview).<sup>17</sup> This measure was widely supported in Congress, although the right advocated a permanent and more substantial reduction. Business associations took a similar position, supporting the reduction but arguing that it was insufficient (Muga 2008, author's interview). Elimination of the stamp tax for small businesses<sup>18</sup> also drew broad support in Congress, since this benefit was targeted at a constituency that both the right and the Concertación had long sought to court. This competition dated back to the early 1980s, when support from small business was critical to the fate of the political struggle against Pinochet in the aftermath of the economic crisis (Silva 1996, 2000). In the 2000s, the UDI and the PDC in particular sought to attract small businesses that were struggling to survive in an economy dominated by larger and more “modernized” firms (A. Velasco 2005, author's interview). Moreover, visibly advocating on behalf of small business formed part of the Alianza's strategy of shedding its public association with the interests of big business, which was interpreted as an electoral liability by the mid-2000s (Chapter 3). Not only did the tax cuts included in the reform package prove attractive to the right on the basis of electoral concerns, but they also appealed directly to the right and business's policy

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<sup>15</sup>Velasco expressed his distaste for tax benefits for the middle class proposed by the PDC during the 2005 electoral campaign and took efforts to exclude such measures from Bachelet's program of government. While several PS legislators asserted that Velasco had opposed restricting the VAT benefit because he viewed it as an incentive for growth in the construction sector, my interviews with Finance Ministry informants and construction sector informants suggested that concerns regarding the sectors' structural power were at best secondary to political considerations. Echeverría (2008), for example, reported that he was unable to convince the Finance Ministry that the 2008 reform proposal was bad for investment and growth.

<sup>16</sup>Cámara de Diputados, Legislatura 355, Sesión 126, Jan. 9, 2008: 13.

<sup>17</sup>See also: Gazmuri, Diario de Sesiones del Senado, Legislature 356, Sesión 4a, March 19, 2008, *El Mercurio*, March 4, 2008: “Gremio constructor advierte que medida subirá precios a los clients.”

<sup>18</sup>Firms with sales under 100 thousand UFs (roughly USD 4 million in 2008) per year were allowed to deduct their stamp tax payments from their VAT obligations. *El Mercurio*, March 4, 2008: “El Gobierno propone rebajas tributarias y prioriza a los automovilistas y a las pymes.”

preferences and anti-tax ideology. Business associations and the right had explicitly advocated each of the tax reductions included in the package in the months and years preceding the reform (Muga 2008, author's interview).<sup>19</sup>

Including the VAT benefit restriction in a reform package dominated by tax reductions also provided the strategic advantage of counteracting two arguments that would likely have been salient had the measure been proposed as an independent reform initiative: that the state did not need additional resources, and that restricting the VAT benefit would be detrimental for economic growth and employment. Because it was designed to finance a permanent tax cut (eliminating the stamp tax for small business), the executive could argue that restricting the VAT measure was essential for maintaining fiscal discipline. Both the gas tax reduction and the advancement of the stamp tax rate reduction, on the other hand, would be financed with interest earnings from state funds invested abroad (author's interviews: Finance Ministry E and F 2008). As such, the executive's request for compensation could be portrayed as reasonable and moderate, despite the context of perceived abundance. In addition, because the VAT benefit restriction was couched in a reform package that could easily be framed as (and was intended to be) pro-growth, arguments based on the structural power of the construction sector would be less convincing (author's interviews: Finance Ministry E and F 2008). In particular, the executive argued that the tax benefit for small and medium enterprises would have a far greater positive impact on job creation than any negative impact from restricting the VAT benefit (Finance Ministry F 2008, author's interview).

The Finance Ministry did not simply rely on the context of the broader reform package to shift attention away from and contain opposition to the restriction of the VAT benefit; instead, the wording of the proposal made each of the tax cuts contingent on approval of the latter measure. Contingency was seen as critical for making the reform feasible, given that the executive anticipated a difficult political battle:

Entre que se nos ocurrió utilizar esta franquicia para financiar este paquete, y que se decidió enviar el proyecto, hubo un intenso debate, porque no queríamos ir con un proyecto que se perdiera. Y no fue una decisión sencilla... no era evidente que estuvieran los votos. Hubo que hacer un análisis muy estratégico de ver cómo se diseñaba el paquete de manera de conseguir que aquellas personas que de haber tenido que discutir esta medida individualmente lo hubieran rechazado, estuvieran dispuestos a aprobarla dado que se presentaba un paquete en que estaba todo unido y una cosa financiaba la otra. ...cada uno de estos artículos ... empezaría a regir cuando entrara en vigencia la modificación de la ley del IVA... Por lo tanto si esta norma se rechazaba, ninguna de las otras iba a poder regir jamás. ...fue la estrategia que nos permitió viabilizar esta reforma. ...de otra forma no hubiéramos podido. Los intereses para defender la franquicia eran muy fuertes. (Finance Ministry F 2008, author's interview)

Finally, the VAT benefit restriction was designed to target upper-income groups, which allowed the executive to defend the reform on the basis of vertical equity. The VAT benefit would be eliminated for homes valued over 4000 UF (roughly USD 168,000 in 2008), which would affect only the top 5% of households.<sup>20</sup> Homes between 2000 and 4000 UF would retain a fraction of the benefit inversely proportional to their value, while homes under 2000 UF would retain the full benefit mandated in the existing legislation.<sup>21</sup> As such, the reform was designed to affect exclusively the top 15% of households. The Finance Ministry adamantly defended the reform on the basis of vertical equity, arguing that it was untenable to subsidize the richest households in Chile and that the reform would have no negative impact

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<sup>19</sup>See also Alfredo Ovalle, CPC: "Discusión en Torno a la Depreciación Acelerada," June 24, 2007, [www.cpc.cl](http://www.cpc.cl); *Segunda*, March 8, 2001: "CPC propone seis medidas," *El Mercurio*, March 4, 2008: "El Gobierno propone rebajas tributarias y prioriza a los automovilistas y a las pymes." The latter article portrayed the stamp tax reductions as a direct response to business's demands.

<sup>20</sup>Mensaje 1469-355, March 3, 2008: 5, Ministerio de Hacienda 2008: 3.

<sup>21</sup>Mensaje 1469-355, March 3, 2008: 5.

on the lower-income and middle class families according to standard classifications used in the national household survey.<sup>22</sup>

Targeting the tax increase at upper-income groups also helped the executive counteract arguments based on the construction sector's structural power, by effectively attenuating the impact of the measure. The proposal would affect only 10% of the housing market, and houses constituted only about 30% of economic activity in the construction sector (author's interviews: Finance Ministry E and F 2008). It would therefore be difficult for the CChC and the right to argue that the reform would have a significant negative economic impact.

However, targeting the VAT reform to affect only upper-income sectors came at the cost of a potentially significant implicit revenue tradeoff: restricting the VAT benefit to homes under a certain value would be extremely difficult to enforce. The Lagos Administrations' Budget Director explained the problem with regard to the Concertación legislators' prior proposal, which followed the same design principle as the 2008 reform:

...el problema es que la propuesta parlamentaria trataba de limitar la devolución del IVA según el tipo de construcciones, pero hay una cierta fungibilidad en el caso de una empresa constructora respecto de que insumos esta usando para que construcción, y eso plantea problemas insolubles de fiscalización. Lo que habría que hacer con la franquicia tributaria para la construcción es simplemente eliminarla por completo y reemplazarla por un subsidio a las viviendas de menor tamaño. (Marcel 2005, author's interview)

Tax agency officials pointed out this very problem in 2005 when the Concertación legislators' bill was discussed in the Chamber of Deputies,<sup>23</sup> and similar concerns were conveyed to the Finance Ministry in 2008 before the reform was sent to Congress (Jorratt 2008, author's interview). However, the Finance Ministry officials were unwilling to consider outright elimination of the special VAT regime because that approach was viewed as politically infeasible.

### **Successes and Limitations of Contingent Benefits and Targeting Elites**

The 2008 reform's strategic design achieved definitive success on two important fronts: neutralizing opposition arguments based on structural power, and preventing active opposition from the broader business community. In terms of crafting support in Congress, however, the executive's strategies achieved more limited success. Contingent benefits and the proposed degree of targeting failed to win enough votes to approve the original version of the bill in the Senate.

On the positive side, the combination of linking the VAT benefit restriction to other tax cuts and targeting its impact made the reform largely invulnerable to business and the right's previous arguments that modifying the regime would hurt jobs and growth. As a government informant recalled:

En este materia nuestros argumentos fueron muy efectivos... la focalización para viviendas por sobre 4,000 UF incide en 0.01% del PIB. Por otro parte, ...nuestra estimación era que la rebaja del impuesto al combustible era estimular el sector privado entre 0.5 y 0.7, además los recursos recaudados se usan para incentivar los PYMES [pequeñas y medianas empresas] que generan empleo y inversión. Por lo tanto el argumento que esto era malo para la economía—la verdad, creo que nadie lo compró. (Finance Ministry F 2008, author's interview)

In fact, arguments that modifying the VAT benefit would have negative economic consequences were much more prevalent during the discussion of the legislators' 2005 reform proposal, which was not

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<sup>22</sup>Informe de la Comisión de Hacienda del Senado, Boletín 5.752-05, March 25, 2008: 15. As reported in *El Mercurio*, Secretary General of the Government Francisco Vidal asserted: "Entre el año 1990 y hoy... 4 mil 700 millones han ido en beneficio del 10% relativo más rico de Chile. Eso es una indecencia," while Velasco declared: "[Que se afecte a la clase media] es una acusación ridícula... Estamos retirando este beneficio para gente que gana más de \$1,8 millón. Esa gente está en el 5% más rico de todos los chilenos. Entonces, ¡por favor!, no nos vengan a decir que eso es clase media," (*El Mercurio*, March 18, 2008: "Hacienda usará un estudio del propio gremio de la construcción para rebatirlo en el Senado").

<sup>23</sup>Enrique Rojas, SII, in Acta, Sesión 244a 2005: 6.

discussed in the context of a broader reform package and which sought to impose a much lower limit on the value of houses eligible to maintain the tax benefit. The CChC built its argument against the 2005 proposal around the claims that in addition to increasing the price of homes, the reform would reduce annual sales by 16%, decrease investment by 18 million UF, and cause the loss of more than 35 thousand jobs (CChC 2005:1).<sup>24</sup> In 2008, in contrast, the CChC and the right made only passing comments in the Senate Finance Committee meetings and in the press to the effect that this component of the reform package would have a negative economic impact. The CChC made a single and much milder reference to growth and jobs during its extensive presentation against the reform.<sup>25</sup>

Linking the VAT measure to more generalized tax cuts also precluded active opposition from the CPC, which was otherwise a concrete possibility given strong cross-sectoral business cohesion. As demonstrated by the copper royalty, the CPC did not limit its activities to cross-sectoral tax issues; business cohesion could result in solidarity even when a single sector was affected. Business informants across sectors interviewed in 2005 (ABIF 2005, Ariztía 2005, F. Gazmuri 2005, Lizana 2005, Morandé 2005) in fact expressed the expectation that the CPC would participate should the executive propose to modify the construction VAT regime in the future. The president of the CPC had declared his opposition to eliminating the tax benefit in 2005.<sup>26</sup> According to the CPC's General Manager, all of the sectoral peak associations sympathized with the CChC's opposition to the 2008 VAT reform; however, CPC leaders limited their involvement to expressing support for the CChC when specifically asked about the measure by the press (Muga 2008, author's interview). The CPC's public statements against the VAT modification were comparatively mild, and pronouncements of support for the tax reductions included in the reform package were more prominent in the press.<sup>27</sup> Moreover, the CPC did not send representatives to the Congressional Finance Committee hearings on the reform, nor did it post official statements against the VAT modification on its web page, in contrast to previous tax reform episodes.

The CPC's General Manager recognized that the strategic design of the reform package contributed to the decision to assume a low profile with respect to the VAT modification and helped prevent business from mobilizing a more effective campaign against the reform:

El gobierno quiso de alguna forma ponerlo todo en un paquete como un estrategia de que todo se aprobara porque la discusión por la franquicia IVA, nosotros lo podíamos hecho mucho mas fuerte demostrando a las personas que era... un beneficio que ellos tenían que... quisiera eliminar. ...como había otros incentivos en el paquete, y el paquete era un todo, la verdad que fue mucho más difícil oponerse. Fue mucho más difícil decir esto no está bien. Tal vez si los proyectos se hubiera podido separar, cosa que el gobierno nunca lo quiso hacer, como una estrategia muy inteligente...  
--Entonces la estrategia del gobierno de juntar esto con los otros dos, fue eficaz? Fue eficaz. Claramente para ellos. Claramente.  
--Porque si no, ustedes hubieran podido frenarlo? Si no, se hubiera podido alargar mas la discusión. Y poner argumentos en cada uno de los temas. Que podía haber agregado un debate mucho mayor. (Muga 2008, author's interview)

Other factors that contributed to the CPC's non-involvement on the VAT reform included the fact that the CChC was well-prepared to wage the battle and did not need or ask for active assistance from the CPC (Muga 2008, author's interview), and the fact that restricting the VAT benefit was perceived as a less far-reaching and less threatening change to the tax system than the copper royalty, which was viewed as a

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<sup>24</sup>See also Morandé, in Informe de la Comisión de Hacienda, Cámara de Diputados, Boletín 3.737-14, July 12, 2005: 3.

<sup>25</sup>The CChC asserted: "el riesgo de contracción de la demanda inmobiliaria, la inversión y el empleo sectorial podrían tener un efecto multiplicador en el resto de la economía," (Hurtado, in Informe de la Comisión de Hacienda, Senado, Boletín 5.752-05, March 25, 2008: 37).

<sup>26</sup>*El Mercurio*, June 9, 2005.

<sup>27</sup>*El Mercurio*, March 4, 2008: "Gremio constructor advierte que medirá subirá precios a los clientes;" *El Mercurio* March 18, 2008: "Hacienda usará un estudio del propio gremio de la construcción para rebatirlo en el Senado;" *El Mercurio* March 21, 2008: "La CPC y la Sofofa apoyan el acuerdo que modificó la franquicia a la construcción."



disincentive for foreign investment, and the subsequent tax on mining, which was seen as a precedent for creating other sector-specific taxes (author's interviews: Muga 2008, Hurtado 2008).

Despite these strategic successes, making the tax reductions contingent on approval of the VAT modification and limiting its impact to the top 15% of households did not secure sufficient support in Congress to pass the original version of the reform. The bill passed with 83 votes in favor and 12 abstentions in the lower house, despite complaints from the right over the VAT modification.<sup>28</sup> However, trouble arose in the Senate. The VAT modification was rejected two to five in the Finance Committee with the votes of PDC Senator Sabag as well as the two Alianza Senators, despite the fact that eliminating the measure technically implied that the tax reductions in the reform package could not enter into effect.

An insufficient degree of targeting given the balance of power in the Senate, a strong CChC lobby that strategically exploited concerns that the modification would affect the middle class, and limitations of the contingency tactic in the particular context of the 2008 reform explain the rejection of the original version of the VAT modification.

The level of targeting proposed by the executive was not high enough to secure unanimous support within the Concertación, let alone opposition votes. Dissent within the PDC reflected a number of factors, including political rivalries within its ranks<sup>29</sup> and a weaker capacity to discipline its members given the controversy that had ensued following the expulsion of Adolfo Zaldívar (Finance Ministry F 2008, author's interview). However, competition with the right for middle class constituencies, along with different views regarding how the "middle class" should be defined and what sectors should benefit from state subsidies, played an important role in the conflict. The dissenting PDC Senators (Sabag, Frei, and Pizarro) argued that households earning 1.6 million pesos (which in practice belonged to the 94<sup>th</sup> percentile) could by no means be construed as rich and should be allowed to retain the VAT benefit.<sup>30</sup> The independents, and naturally the right, shared the dissenting PDC Senators' views. Although the failure to win over the independent senators would have ensured the bill's defeat, dissent within the government's ranks weakened the executive's bargaining position.

The CChC astutely ascertained that exacerbating concerns over the impact on the middle class would be the most effective strategy against the reform, which it fervently opposed. The CChC argued that the 2008 proposal would have a greater impact and was less targeted than the government's calculations indicated. CChC representatives asserted that the proposal would affect households belonging to as low as the 23rd percentile and that housing prices would increase by 8% rather than the government's projection of 4%.<sup>31</sup> The Finance Ministry systematically countered these arguments, pointing out that their calculations relied on data previously published by the CChC itself, as well as public information from the CASEN household survey and banks' minimum income requirements to qualify for home loans.<sup>32</sup> In fact, it appears that the CChC may have deliberately manipulated the assumptions and data underlying its calculations in order to depict the reform as affecting the greatest possible percentage of households.<sup>33</sup>

The CChC's campaign may have tilted the balance in Congress against the reform. While the handful of PDC Senators may have objected to the original draft of the VAT modification even if the CChC had not produced calculations to suggest that the proposals' impact would be broader than the government maintained, the CChC's presentation probably exacerbated the PDC's concerns. According to the former CChC president who coordinated the sector's lobbying in congress: "Cuando nosotros les demostramos que afectaba a gente que estaban ganando... ingresos mensuales de mil dólares, allí fue cuando los parlamentarios del mismo gobierno decidieron votar en contra de esto y se subió el tope..."

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<sup>28</sup>*Cámara de Diputados, Legislatura 355, Sesión 139, March 6, 2008.*

<sup>29</sup>Frei was allegedly trying to distinguish himself from Alvear to position himself as a presidential candidate for 2009

<sup>30</sup>Sabag, in Informe de la Comisión de Hacienda, Senado, Boletín 5.752-05, March 25, 2008: 18.

<sup>31</sup>Hurtado, in Informe de la Comisión de Hacienda, Senado, Boletín 5.752-05, March 25, 2008: 35. One consulting firm cited in the press claimed that the government's proposal would affect as much as 38% of homebuyers (*Estrategia*, May 3, 2008: "Recorte a Beneficio de Constructoras Afectará al 38% de los Compradores").

<sup>32</sup>Ministerio de Hacienda 2008.

<sup>33</sup>*El Mercurio*, March 18, 2008: "Hacienda usará un estudio del propio gremio de la construcción para rebatirlo en el Senado."

(Echeverría 2008, author's interview). In addition, the CChC's efforts may have helped consolidate opposition to the reform from the right parties; several opposition legislators had been open to restricting the VAT benefit,<sup>34</sup> but as one informant recalled, they firmly opposed the measure in light of the CChC's arguments (Montes 2008, author's interview).

Meanwhile, contingency of the tax cuts on approval of the VAT modification failed to protect the executive from pressure to preserve the tax benefit for a larger percent of households. The executive perceived a credible threat that the right, the independents, and the PDC dissidents would vote against the VAT reform on the Senate floor (author's interviews: Finance Ministry E and F 2008, Montes 2008), contingency notwithstanding. Legislators may have been willing to vote against the VAT measure even if so doing jeopardized the popular tax cuts for a number of reasons. First, from the right's point of view, the government could be expected to share some of the blame for delaying the tax cuts if the executive refused to negotiate, especially given that members of the governing coalition objected to the original proposal and were also disposed to vote against the reform. Second, the right and the dissident PDC senators may have expected that electoral benefits associated with publicly defending the "middle class" and rejecting the original VAT measure would outweigh any costs associated with delaying the other tax cuts. Legislators who voted against the VAT measure could point to the vote record to indicate their approval of the tax cuts; the executive faced the harder task of framing opposition to the VAT measure as implicit rejection of the tax cuts given the design of the reform package.<sup>35</sup> Third, the executive could not credibly threaten to allow the tax cuts to die if the VAT measure were rejected. Actors understood that the executive was committed to quickly enacting the tax cuts.<sup>36</sup> The Finance Ministry believed the tax cuts would stimulate the economy, and these measures could benefit the Concertación electorally as well.<sup>37</sup> And with municipal elections approaching, the government needed to preserve unity within the coalition; prolonging congressional debate over the VAT measure could have exacerbated conflicts both between the PDC and the PS and within the PDC itself. Therefore, in this context, contingency acted as a double-edged sword, providing incentives for the executive, as well as the opposition, to negotiate compromises on the VAT measure for the sake of the broader reform package. In fact, the executive ultimately used contingency of the tax cuts to compel the Concertación's own left-wing to accept the VAT compromise negotiated with the right and the PDC dissidents.<sup>38</sup>

Although contingency did not protect the original reform from modification, contingency nevertheless played an important role in facilitating the VAT reform. Had the executive not made use of this strategy, the opposition would have been in a much stronger bargaining position. The modification may have taken much longer to legislate, and the right may ultimately have secured a deal even more favorable to the CChC and upper-income consumers. The right and the CChC (along with the PDC dissidents) in fact complained stridently about this strategy and unsuccessfully demanded that the measures included in the package be discussed independently on the basis of their own individual merits (Finance Ministry F 2008, author's interview).<sup>39</sup>

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<sup>34</sup>*El Mercurio*, April 24, 2001: "Denuncian Evasión al Amparo del DFL 2."

<sup>35</sup>In addition, Finance Ministry informants expressed some concern regarding the legal robustness of the contingency measures to challenges from the right should the tax cuts have been approved (Finance Ministry E 2008, author's interview).

<sup>36</sup>The construction sector for example believed this to be the case (Echeverría 2008, author's interview).

<sup>37</sup>*La Segunda*, March 4, 2008: "Ministro de Hacienda y rebaja de impuestos a bencinas: Hará caer la inflación," *El Mercurio*, March 4, 2008: "El Gobierno propone rebajas tributarias y prioriza a los automovilistas y a las pymes."

<sup>38</sup>"...el senador Camilo Escalona (PS), presidente de la Comisión de Hacienda de la Cámara Alta, acusó que su posición fue objeto de una 'extorsión,' porque, si se oponía al arreglo con la Alianza y la DC, se pospondría otro de los artículos del proyecto: la rebaja del impuesto específico a las gasolinás." *El Mercurio*, March 21, 2008: "La CPC y la Sofofa apoyan el acuerdo que modificó la franquicia a la construcción." See also *Diario de Sesión, Cámara de Diputados, Legislatura 356a, Sesión 9a*, March 20, 2008: 18. Montes (PS) asserted: "lo consistente sería votar en contra las modificaciones del Senado, para mejorar el proyecto en Comisión Mixta. Pero eso significaría postergar su puesta en práctica y la rebaja de la gasolina." PDC deputies Saffirio, Mulet, and Lorenzini expressed similar sentiments (p. 18, 21, 26).

<sup>39</sup>*Diario de Sesiones del Senado, Legislatura 356, Sesión 4a*, March 19, 2008: 50, 93; *El Mercurio*, March 7, 2008: "Cámara cuestiona fórmula que elimina franquicia a construcción," Hurtado, in *Informe de la Comisión de Hacienda, Senado, Boletín 5.752-05*, March 25, 2008: 37.

### **The Outcome: Significant Revenue Loss but Contained Conflict**

Ultimately, the executive agreed to significantly increase the degree to which the VAT measure targeted upper-income households in order to maneuver the reform through the Senate. The maximum home value above which the VAT benefit would no longer apply was increased from 4000 to 4500 UF (roughly USD 188,000 in 2008) and homes under 3000 UF (roughly USD 126,000 in 2008) rather than 2000 UFs maintained the full benefit.<sup>40</sup> With these changes, the reform would only affect the richest 5-7% of households (author's interviews: Finance Ministry E and F 2008).

On the one hand, this agreement entailed a heavy financial cost. Government informants estimated that the VAT benefit modification approved by Congress would raise about 135 million dollars per year, whereas Concertación legislators asserted that it would raise as little as 118 or 110 million dollars.<sup>41</sup> Accordingly, the executive lost somewhere between 29% and 42% of the revenue it had originally hoped to raise. And in practice, the VAT modification could generate even less revenue than anticipated, due to the difficulty of controlling evasion that is inherent in the reform design. Thanks to the modifications, the overall reform package entailed a permanent fiscal cost of 55 to 80 million dollars per year; the VAT benefit was not reduced enough to compensate for elimination of the stamp tax for small businesses.

On the other hand, the concessions helped the government legislate the reform quickly and minimize conflict, within the coalition as well as with the right and the CChC. The reform was approved only 17 days after the executive sent the initiative to Congress. Finance Ministry informants expressed satisfaction with having contained conflict with the CChC, although they asserted that they devoted their best efforts to defending the reform against its attacks:

No entramos en una confrontación con el gremio por que no creemos que es bueno para el país. Si ...desacreditamos el gremio, y el gremio queda mal frente al país, o quedaban en enemistado con las autoridades, tampoco es bueno para el país, el país tiene que vivir en un ambiente de convivencia sana. (Finance Ministry F 2008)

Indeed, although CChC informants were upset that the executive had initiated the reform and asserted that restricting the benefit in any way violated their rights and basic principles of taxation, they were in practice quite satisfied with the outcome of the negotiations (author's interviews: Echeverría 2008, Hurtado 2008). Likewise, the CPC president applauded the final agreement in the press.<sup>42</sup>

Finance Ministry informants, moreover, expressed the conviction that they had achieved the best deal possible given the constraints they faced (author's interviews: Finance Ministry E and F 2008). Concertación legislators who had pioneered the struggle to eliminate the VAT benefit were less satisfied with reform (Montes 2008, author's interview). However, they acknowledged that a step had been taken in the correct direction, and assured that they would continue to pressure for further reform: "No ha terminado el debate. Dio un paso." (Montes 2008, author's interview). In final evaluation, this reform is best viewed as part of a long-term, incremental process toward improving tax equity, of the same sort that eventually led to the elimination of the tax benefit for stockholders and the legislation of the tax on mining.

This reform illustrates both the advantages and limitations of targeting tax reforms at upper income groups and including contingent links to benefits. On the one hand, both of these strategies were critical for restricting the VAT benefit. This case study in fact illustrates that even in Chile, where business and the right ideologically oppose taxation and defend the interests of upper-income groups, targeting economic elites can be an effective strategy. On the other hand, the political space created by these strategies was quite narrow. The final reform package was revenue-negative, and the legislation preserved a tax break for households in the top 90<sup>th</sup>-95<sup>th</sup> percentiles.

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<sup>40</sup>Ley 20.259, Article 5; *El Mercurio*, March 19, 2008.

<sup>41</sup>Montes and Insunza, in *Diario de Sesión, Cámara de Diputados, Legislature 356a, Sesión 9a*, March 20, 2008:12, 20.

<sup>42</sup>*El Mercurio*, March 21, 2008: "La CPC y la Sofofa apoyan el acuerdo que modificó la franquicia a la construcción."

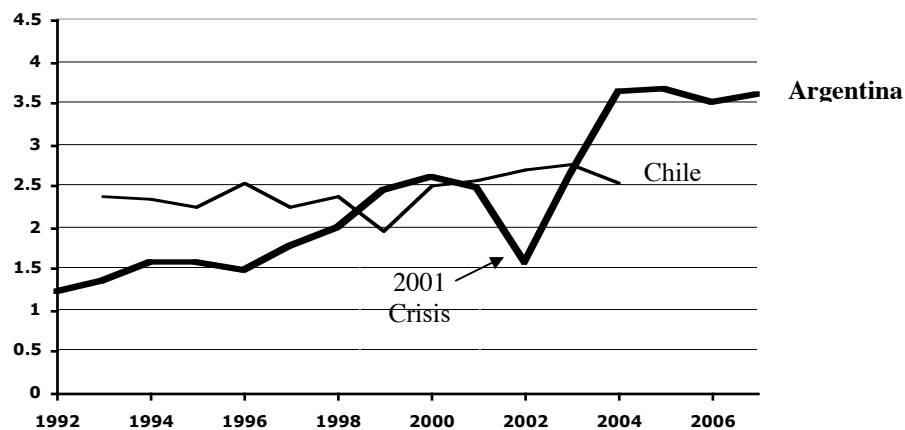
## Chapter 5. Corporate Taxation in Argentina: Weak Business Power Facilitates Reform

Whereas only marginal corporate tax reform was possible in Chile after the 1990 transition to democracy, corporate tax reform in Argentina in the aftermath of first generation VAT-broadening reforms and currency stabilization (1989-1991) was quite significant. While Chile's corporate tax rate remained the region's lowest in 2005 at 17%, successive reforms increased Argentina's corporate tax rate from 20% to 35%, the highest rate in Latin America. Additional reforms in Argentina closed corporate tax loopholes and granted the tax agency greater powers to fight income tax avoidance and evasion. These reforms were not cosmetic; they contributed to noteworthy growth in corporate tax revenue from 1992 to 2006 and the largest increase in total income tax revenue in Latin America from the early 1990s to the early 2000s (Sabaini 2005: 32).<sup>1</sup> Whereas corporate tax collections held essentially constant in Chile at an average of 2.4% GDP, Argentine collections grew from 1.2% GDP in 1992 to 3.7% GDP in 2005. Argentina's corporate tax revenue caught up to Chile's by 1999 and surpassed Chilean collections after recovering from the 2001 economic crisis (Figure 5.1).

This chapter argues that business's much weaker instrumental power at the cross-sectoral level explains Argentina's greater progress on corporate tax reform compared to Chile. Section I argues that as in Chile, structural power tended to be weak and only occasionally constrained corporate tax policy. Section II describes the absence of the key sources of instrumental power that allowed business in Chile to effectively resist increased corporate taxation. Business in Argentina did not enjoy partisan linkages to any party with significant representation in congress. Business lacked cohesion at the cross-sectoral level, and the nature and strength of business relationships with the executive branch varied across sectors. In the context of weak cohesion, each sector focused on pursuing its own interests rather than defending shared business "class" interests. The executive was able to divide and conquer business opposition to reform by offering sector-specific compensations and/or emphasizing horizontal equity. Meanwhile, vertical equity appeals consolidated support for reform in congress. Section III examines two reform case studies that illustrate these dynamics as well as one case that serves as an exception that highlights the general pattern of weak business influence over corporate tax policy.

**Figure 5.1: Corporate Tax Revenue, % GDP.**

Sources: DNIAF 2007, SII 2005.<sup>2</sup>



<sup>1</sup>Administrative improvements also helped increase revenue in Argentina (Eaton 2002), where enforcement was historically weaker than in Chile. However, closing loopholes and expanding tax agency powers are critical for controlling evasion.

<sup>2</sup>Chilean data constructed with help from Jorratt. Series ends in 2004; in 2005, copper windfalls exogenously increased revenue.

**Figure 5.2: Type and Estimated Revenue Impact of Corporate Tax Reforms, 1992-2005**

CHILE			ARGENTINA		
Year	Reform Type	% GDP/yr*	Year	Reform Type	% GDP/yr**
1990	Tax Rate	~2.0	1992	Tax Rate and Base Broadening	~1.5-2.0
			1996	Tax Rate and Closing Loopholes	~0.4
1998	Base Broadening	~0.1	1998	Tax Rate and Closing Loopholes: --Corporate Assets Tax --Tax on Interest	~0.6
2000	Base Broadening and Closing Loopholes	~0.1	1999	Closing Loopholes: Transfer price regulations	NA
2001	Tax Rate	~0.1	2003	Closing Loopholes: --Transfer price regulations	~0.002

\*Source: government estimates from Chilean congressional records.

\*\*There is no consistent record of official revenue estimates in Argentina. Figures draw from news sources and various official records.<sup>3</sup>

### I. Business's Weak Structural Power

Literature on globalization and taxation would have predicted a strong role for structural power in Argentina during the 1990s, given the context of economic liberalization and reduced controls on international capital flows, as well as the country's history of hyperinflationary episodes and capital flight. However, structural power in fact exerted limited influence on corporate tax policy in Argentina. Taxes are one among many factors that affect investors' decisions, and Argentina's overall policy mix in the 1990s was highly attractive, given privatization at bargain prices and minimal regulation.<sup>4</sup> Policymakers from the Menem (1996-99) administration expressed little concern that the moderate corporate tax increases they pursued would discourage investment. Despite high capital mobility, these tax increases were not expected to set off a flight reaction, given that policies in multiple other areas greatly benefited investors. In the words of former Economy Minister Fernández (2005, author's interview): "...we were completely friendly toward national and foreign capital. ...At that time, everyone wanted to invest and take risks in Argentina. So we said to them: good, then pay income tax."

As in Chile, concerns regarding investment occasionally shaped the design of corporate tax reforms, but structural power did not preclude corporate tax increases. In 1992, concern regarding the macroeconomic consequences of a radical corporate tax reform voiced by independent tax experts and legislators contributed to the executive's decision to withdraw the proposal, but the executive proposed a more conventional corporate tax increase thereafter that raised the same amount of revenue without activating concerns over investment. In 1999 the executive avoided corporate tax increases for fear of negative economic consequences, given the context of recession and pressures on domestic firms associated with the overvalued exchange rate,<sup>5</sup> as De la Rúa's (1999-2001) former Economy Minister explained (Machinea 2007, author's interview). Facing urgent revenue needs in the context of soaring debt, the Alianza government therefore opted to increase individual income taxes rather than altering the corporate tax rate. However, the 1999 reform also strengthened transfer price regulations, which helped

<sup>3</sup>For the 1992 reform: *Clarín* March 13, 1992: "Habra mayor recaudación" and DNIAF 2007. For the 1996 reform: *Clarín*, Aug. 23 1996: "El oficialismo, en silencio," *Cronista*, Sept 4. 1996: "Volverían atrás con la suba de Bienes Personales." For the 1998 reform: DNIAF 2007. For the 2003 reform: Acta, Comisión de Presupuesto y Hacienda, Oct. 4, 2006: 26.

<sup>4</sup>Argentina ranked among the top 13 of over 150 countries on the Heritage Foundation's "Economic Freedom Index" from 1996-1999 (available online).

<sup>5</sup>The Convertibility regime pegged the peso to the dollar and tied monetary expansion to growth in reserves.

to extract more revenue from multinational firms. After the 2001 crisis, governments avoided raising tax rates to promote investor confidence, but they viewed closing corporate tax loopholes as unproblematic (former Economy Minister Miceli 2008, author's interview). For example, the Kirchner administration (2003-07) legislated stricter transfer-price regulations to control tax avoidance involving transactions with subsidiaries in tax havens, along with other powers designed to enhance the tax agency's ability to control income tax evasion. Exporters protested that the reform would destroy futures markets and undermine growth and investment in the grain sector, but former Economy Minister Lavagna (2006, author's interview) and former tax agency director Abad (2008, author's interview) asserted that they were always confident the reform would have no negative effects on the basis of their own technical assessments.

## II. Business's Weak Instrumental Power at the Cross-Sectoral Level

Business's instrumental power at the cross-sectoral level was weak in Argentina. Business lacked cohesion and therefore could not effectively mobilize collective action against reforms. Relationships with legislative policymakers were weak—Argentina has no electorally relevant right party with business as a core constituency, and informal ties to legislators were not an effective means of influence. Meanwhile, relationships with executive policymakers created instrumental power at the sectoral level or lower. While certain sectors enjoyed recruitment into government or informal ties to executive authorities during delimited time-periods, those sectors tended to pursue their own specific interests rather than defending common business interests.

### Lack of Cohesion

Business in Argentina has very little capacity to unite and engage in collective action at the cross-sectoral level. Weak organization and the absence of strong ideological views on taxation contribute to business's lack of cohesion.

In contrast to Chile, business associations in Argentina are among the weakest and most fragmented in Latin America (Schneider 2004: 196, Acuña 1998). Despite multiple attempts, business failed to create an enduring encompassing peak association due to persistent conflicts between sectors (Schneider 2004, Acuña 1998: 61-65). As Schneider (2004: 174) recounts:

...big business created numerous encompassing associations. However, the jumble of acronyms generated by these mobilizations signified little more than transitory coordinating efforts... By the 1980s coordinating groups had dropped the custom of creating new acronyms and referred to themselves simply by the number of associations involved: '*grupo de los 8*' or '*grupo de los 12*.'

Not only does Argentina lack a cross-sectoral peak association, but sectoral-level associations tend to be weak as well, with a few exceptions. For example, Schneider (2004: 173) argues that "encompassing associations in agriculture and industry faced competing associations and lacked institutional resources," (Schneider 2004: 173). In fact, as Acuña (1998: 65) observes:

...intrebusiness contradictions and conflicts affected the *entire* spectrum of business organizations, from the first to the fourth degree, and generated a pattern of permanent tensions horizontally (between economic sectors and branches) and vertically (within the same branch, between forward and backward linked producers).

Accordingly, most sectoral associations lack the capacity to forge common positions among their own members. Weak capacity for interest intermediation or aggregation at the sectoral level undermines sectoral cohesion and also hinders construction of cross-sectoral alliances.

Authors have attributed business's organizational weakness to different factors. Schneider (2004: 173) emphasizes interventions by political leaders who sought to organize supporters and demobilize opponents within the private sector: "Over time these attempts exacerbated and reinforced existing economic cleavages, making encompassing collective action increasingly difficult." Such interference was particularly pointed under Peronist rule. Parallel associations of pro- and anti-peronist business factions, as well as politically salient divisions between transnational and domestic bourgeoisies, created

an enduring legacy of fragmentation (O'Donnell 1978, Schneider 2004: 177).<sup>6</sup> Acuña (1998: 57) in turn argues that instability of regimes, economic policy, and institutions dissuaded business from investing in encompassing peak associations: "...strategies based on common interests, which had to be anchored in mid- to long-term objectives, were inherently uncertain and risky. Caught in the logic of the prisoner's dilemma, Argentine social actors adopted a highly rational behavior at the individual-sectoral level, which frustrated collective interests."

Additional factors that may help create business cohesion, like shared ideology or a strong common identity defined with respect to other social actors, are also absent in Argentina. While many business groups benefited from neoliberal reforms in Argentina (Schamis 1999, Etchemendy 2004), business did not hold strong ideological views on taxation, in contrast to their Chilean counterparts (author's interviews). Instead, business attitudes towards taxes were more pragmatic. While business opposed increased taxation, taxes were viewed as one of many policies that affect profitability. Ideological opposition to taxation based on expansive views of property rights appears to be a largely Chilean phenomenon rooted in the experience of class struggle under Allende's socialist experiment and the influence of the Chicago School of Economics prior to and during the Pinochet dictatorship. The less pervasive influence of radical neoliberal ideology in Argentina compared to Chile is also evidenced in the more substantial contingent of heterodox economists to be found in national universities, think tanks, and public institution advisory boards.<sup>7</sup> Likewise, whereas class conflict and polarization in the 1930s, 1960s and 1970s helped consolidate a strong common identity among Chilean capitalists that contributed to cohesion,<sup>8</sup> episodes of conflict sparked by labor mobilization and redistributive policies in Argentina did not forge lasting business solidarity. As Acuña (1995) argues:

...las contradicciones entre capitalistas y trabajadores no necesariamente constituyen el principal determinante de la lógica de organización y comportamiento de la burguesía como actor político... las líneas de conflicto y alianzas que determinan los patrones organizativos de la acción colectiva de los capitalistas, tienen como su causa predominante al conflicto con otros sectores capitalistas o con el estado.

Lack of cohesion weakened business's ability to defend common interests by creating opportunities for the government to divide and conquer. While all of business tended to oppose cross-sectoral tax increases, the executive could prevent collective action by offering sectoral compensations with relatively low fiscal cost. Other authors have described the use of similar government strategies for passing market reforms in Argentina during the 1990s. Etchemendy (2001), for example, describes how selective compensations negotiated with the largest and most concentrated firms facilitated deregulation and privatization in the steel, auto, and petroleum sectors. Viguera (2000: 186-8) discusses the importance of sectoral payoffs, and even selective punishments,<sup>9</sup> in managing business opposition to trade liberalization and other policies pursued by Menem that went against established business interests.

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<sup>6</sup>Schneider (2004: 187-89) argues against the idea that organizational fragmentation simply resulted from particularly strong economic cleavages among business in Argentina, for example, industry versus agriculture (see for example O'Donnell 1978). Schneider notes that a history of diversified ownership spanning different economic sectors could have created the basis for strong encompassing organization in the absence of political manipulation of business cleavages.

<sup>7</sup>For example, a group of economists from the Universidad de Buenos Aires formed the Fenix Group in 2000, which advocated heterodox economic policies (econ.uba.ar/planfenix). One of these economists, Jorge Gaggero, worked as an advisor for Banco de la Provincia de Buenos Aires. The Universidad de La Plata also hosted a group of heterodox economists, some of which became Economy Ministry advisors during the Kirchner administration.

<sup>8</sup>See Chapter 3, and among others, Drake 1978, Silva 1996, and Schneider 2004.

<sup>9</sup>According to Viguera (2000: 188): "Para los empresarios individuales alzar demasiado la voz podía tener incluso consecuencias negativas inmediatas en un contexto en el que no dejaban de operar las presiones explícitas o implícitas para moderar los reclamos: varios entrevistados coincidieron en señalar que la tendencia a oponerse a Cavallo se veía frenada porque 'nadie quiere arriesgarse a que le caiga por sorpresa una inspección de la DGI, o a que se le niegue un crédito...' Por otro lado, las concesiones obtenidas por 'los amigos' del gobierno podían ser la vía por la cual se beneficiaba un sector en su conjunto, como ocurría con la industria textil."

## **Weak Relationships with Legislative Policymakers**

Argentina has no electorally relevant right-wing party that serves business or upper-income individuals as core constituencies. Business therefore lacked the partisan linkages that provided their Chilean counterparts with reliable allies in congress. Meanwhile, informal ties to legislators were a weak source of instrumental power thanks to institutional incentives that encouraged discipline within the two major political parties as well as legislators' tendency to support initiatives to tax big business.

### ***Absence of Partisan Linkages***

The absence of a right party in Argentina can be attributed to two factors. On the one hand, regional divisions among elites created a legacy of organizational fragmentation on the right (Gibson 1996). On the other hand, conservatives tended to abandon party-building endeavors when opportunities arose to participate directly in policymaking through connections to the executive branch, particularly under military rule (Gibson 1996: 27). In the 1980s, the right was compelled to undertake more concerted party-building efforts, given that the military was no longer available as a political ally after the transition to democracy (Gibson 1996: 101). The *Union del Centro Democrático* (UCEDE) gradually emerged as an electorally viable right party capable of attracting middle class voters away from the Radical Party and winning a handful of seats in the national congress. However, Menem's decision to implement liberalizing reforms advocated by the UCEDE and his incorporation of key UCEDE leaders into his administration led to the "dramatic organizational and electoral collapse" of this incipient right party in the early 1990s (Gibson 1996: 204). Once again, conservative leaders abandoned the party project when provided channels of access to state power. When deprived of such access after 2002, conservatives had no viable political party through which to seek representation in congress.

Business, meanwhile, sought independence from political parties in general and provided no impetus for the consolidation of a right party (McGuire 1995: 201, 233, Gibson 1996: 28, 159, Acuña 1998, Schneider 2004: 195). Like conservative leaders, business preferred to deal directly with the executive branch:

Due to the instability of the party system and of the rules that governed participation in policymaking and conflict resolution, the business sector cultivated its independence from political parties. ...independence from political parties permitted some business groups to avoid costs and obtain benefits during the long periods of repression or proscription of the party of their sympathy. Raising demands and exerting pressure directly on the executive branch permitted these business groups to articulate their organizational logic in terms of the only relatively stable institutional power available. By not taking the Congress ...very seriously, such representatives of business interests could avoid the protracted, self-defeating task of becoming entangled in institutional channels of doubtful capacity for conflict resolution, whose instability affected not only operational criteria but also the institutions' own continuity. (Acuña 1998: 58)

Even during the UCEDE's ascent in the 1980s, business remained reluctant to rally behind the party, despite the UCEDE's endeavors to cultivate business as a constituency.<sup>10</sup> Individual businessmen did support the UCEDE, but as Gibson (1996: 163) argues: "This support was dependent ...on the ideological commitment of individuals rather than on a shared sense in the business community of the importance of conservative party politics to the pursuit of protection of their class interests."

Not only does Argentina lack a right party, but legislators from both the Peronist party (PJ) and the Radical party (UCR), which together dominated congress from 1992-2006, tended to be relatively unsympathetic to the interests of big business and agreed that the tax system should be more progressive (author's interviews). Taxing big business and multinational corporations was especially popular with

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<sup>10</sup>As Gibson (1996: 159) argues, business's reluctance to rally behind the UCEDE arose from the fact that the free-market ideology espoused by the party went against the economic interests of much of the business community, as well as the fact that business preferred to seek policy input through channels of communication with the executive branch.



legislators, particularly as an alternative to increasing taxes on wage-earners, a core Peronist constituency, and independent professionals, a core Radical constituency. Therefore, the executive encountered little resistance in congress when seeking to increase corporate taxation; appeals to vertical equity tended to be quite effective at consolidating support from legislators. For example, reforms under both Peronist and Radical administrations that strengthened transfer price regulations to control tax avoidance involving exports to subsidiaries in tax havens were welcomed by the governing coalition and the opposition alike.

### ***Limited Effectiveness of Informal Ties to Legislators***

Individual businessmen and specific business interests occasionally enjoyed informal ties to parties or individual legislators. A few business association leaders even became representatives in congress. For example, Claudio Sebastiani, a PJ deputy, simultaneously served as president of the industrial association (UIA) from 1997 to 1998.<sup>11</sup> However, informal ties to the two main political parties usually did not constitute an effective source of instrumental power because of strong party discipline (Jones 2002) and incentives created by Argentina's electoral institutions. As Eaton (2002: 135-141) argues, party-centered electoral incentives, including proportional representation via closed lists controlled by national and provincial party officials, limited legislators' responsiveness to special interest groups, including business associations. During Menem's first term, while he was both president of the nation and the most important authority within the governing party, Peronist legislators had particularly strong incentives to support the executive's reform proposals.<sup>12</sup> Breaches of discipline occurred primarily when reforms went against the interests of regional party authorities (often governors of the provinces), who also exerted significant influence over the career paths of legislators representing their provinces. Discipline within the governing party did weaken on occasion, for example, during Menem's second term when his influence within the Peronist party and his control over legislator's career prospects declined (Eaton 2002). Under these conditions, business had greater chances for winning modifications to bills in congress. However, as evidenced in the empirical sections of this chapter, lobbying in congress tended to succeed primarily, and only to a limited extent, when a convincing case could be made that the proposed reform would negatively affect small and medium businesses, as opposed to big business or multinational firms.

### **Sector-Specific Relationships with the Executive Branch**

While government-business relations created instrumental power at the cross-sectoral level in Chile, government business relationships created instrumental power at the sectoral level or lower in Argentina. Given the fragmentation of the business sector, those sectors or firms that enjoyed favorable relationships with executive policymakers tended to lobby primarily on sector-specific issues and did not actively defend common interests.

Executive-business relations in Argentina have been characterized by selective government consultation with individual businesspeople, economic groups, or sub-sectors, informal ties between executive branch officials and particular business interests, and occasional recruitment of specific sectors into government. Instrumental power with respect to the executive branch has varied widely both over time and across sectors. While Menem generally ignored the business associations, he did regularly consult with businessmen from the largest firms (Schneider 2004: 192). Etchemendy (2004: 63), for example, describes how the Menem administration pursued deregulation in various industrial sectors by inviting the largest and best-established firms to the bargaining table, a process he refers to as "corporatist restructuring through selective concertation." Moreover, financial sector leaders were recruited into government during Menem's first term in office, and they enjoyed informal ties to executive

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<sup>11</sup>*La Nación* March 29, 1997: "Sebastiani: El nuevo titular de la UIA." Guillermo Alchouron, former president of the SRA (1984-1990), which represented large agricultural producers, also served in congress from 1999-2003 as a deputy for Acción por la Republica, a party with minimal representation in Congress founded by Menem's former Economy Minister Domingo Cavallo.

<sup>12</sup>See also Jones 1997 and De Riz and Smulovitz 1991.

policymakers throughout the 1990s; agricultural producers, meanwhile, had informal ties to the Secretary of Agriculture (see Chapter 6).

Although in theory, sectors like finance that enjoyed instrumental power through privileged relationships with the executive branch could have used their power to influence cross-sectoral tax policy, in practice, those sectors sought to defend only their own specific interests and did not lobby actively on cross-sectoral tax issues.<sup>13</sup> This behavior is unsurprising, given weak business cohesion in Argentina. Moreover, the potential for obtaining selective benefits by negotiating directly with the executive branch discouraged broader collective action (Viguera 2000: 189). The sectoral-level nature of instrumental power therefore reinforced the government's ability to neutralize opposition to cross-sectoral tax increases.

### **III. Business's Limited Influence over Corporate Tax Reform: Three Case Studies**

Business in Argentina exerted limited influence over the reform agenda and the fate of executive reform proposals in the realm of corporate taxation, given weak instrumental power and the absence of structural power during most of the 1990s and early 2000s. A number of case studies elucidate this pattern. The Menem administration's 1998 tax reform illustrates how the executive was able to divide and conquer opposition in a context of low business cohesion and weak business relationships with legislators. Appeals to equity, meanwhile, served to build support for the reform in congress. The Kirchner administration's 2003 reform to control tax avoidance among exporters further illustrates the pattern of weak business influence on corporate taxes; Argentina's most important grains export firms failed to obtain concessions from the executive or from congress, despite strong opposition and concerted lobbying. Finally, the case of a radical but unsuccessful 1991 tax reform proposal serves as an exception that highlights the rule of weak business influence on corporate taxes. Unusually intense business opposition, circumstantial allies, and a fortuitous convergence of interests with legislators were needed to compensate for weak instrumental power and to convince the Economy Ministry to withdraw the proposal. The alternative income tax reform subsequently proposed, which raised a similar amount of revenue without drastic revision of the tax code, was legislated without difficulty, conforming to the general pattern.

#### **The 1998 Reform**

The executive successfully divided and conquered business opposition to corporate tax increases proposed in 1998 by offering selective compensations. Given weak business cohesion and the absence of other sources of instrumental power, these concessions were of minimal cost compared to the revenue raised by the corporate tax increases. Meanwhile, the executive built support for the reform in congress by making equity appeals. These appeals facilitated congressional approval at a time when the president's authority within the Peronist party had significantly declined.

#### ***Corporate Tax Reform: Controlling Evasion and Avoidance***

The Economy Ministry presented a tax reform package in 1998 that contained two new corporate taxes—an assets tax (*Impuesto sobre la Ganancia Mínima Presunta*, a tax on minimum presumed income) and a tax on interest payments (*Impuesto sobre los Intereses Pagados y el Costo Financiero del Endeudamiento Empresarial*)—and a corporate income tax rate increase from 33% to 35%. These corporate taxes, along with other proposed tax increases, would compensate a gradual reduction of employers' payroll taxes, which Menem's economic team viewed as important for stimulating recovery and job creation in the aftermath of the Tequila crisis (Guidotti 2006a, author's interview). Together, the two new corporate taxes would address the continued problem of income tax evasion and avoidance. Former Secretary of the Treasury Guidotti (2006, author's interview) described the problem as follows:

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<sup>13</sup>In a somewhat similar vein, Freidan (1991: 20-2) argues that policies affecting specific assets—assets that are of value only for a particular economic activity—will elicit the strongest lobbying efforts.

...cuando miramos el impuesto a las ganancias de las empresas ...vimos que básicamente 17 empresas pagaban más o menos dos tercios de todo el impuesto a las ganancias de las empresas. Un numero ridículo. ...Una gran infinidad de empresas nunca pagaban nada, no reportaban ganancias.

In this context, the assets tax would serve two purposes. First, it would compel businesses that did not report profits, which included some of the largest corporations in Argentina, to make a minimal contribution to state coffers. The assets tax would be credited against the income tax, such that it would not affect firms that reported taxable profits. Second, the assets tax would help reduce evasion of the individual assets tax. Individuals frequently registered property and assets to corporations in order to avoid taxation (Guidotti 2006a, author's interview). Adding a corporate assets tax would close this source of revenue-loss by restoring symmetry to the tax system.<sup>14</sup>

The tax on interest payments, meanwhile, was intended to close a major loophole in the income tax system—non-taxation of interest earnings. This tax is discussed in greater detail in Chapter 6, Part 1. At present, it suffices to note that the tax on interest payments would curtail loss of revenue due to a commonly employed tax evasion scheme known as a “back-to-back” (Thirsk 1997: 26), whereby businesses would deposit funds in a bank, borrow back from that same bank, and deduct the interest paid from their tax obligations.

### ***Dividing and Conquering Business Opposition***

The proposed new corporate taxes and corporate income tax rate increase stimulated business opposition across sectors. Industry, for example, vociferously complained that the tax on interest was unacceptable given that businesses faced high interest rates in the aftermath of the East Asian crisis (Guidotti 2006, author's interview, Sidicaro 2002: 21). Agriculture, which was squeezed by overvaluation of the peso, unfavorable international prices, and high levels of debt, objected that the government should reduce spending rather than increasing taxes.<sup>15</sup>

Early on, the “Group of Eight,” an informal group composed of presidents from each of the major peak associations that met sporadically during the 1990s,<sup>16</sup> convened to coordinate a united cross-sectoral lobby.<sup>17</sup> The Group of Eight drafted a document that harshly criticized the tax reform, denouncing it as distortionary and recessionary and calling on the government to reduce spending and improve tax administration instead (after praising Menem's economic model).<sup>18</sup>

However, business' lack of cohesion allowed the government to divide and conquer by offering sector-specific compensations to the member associations. The construction association withdrew its support for signing a joint declaration against the tax reform after the government announced it would halt a highway project that the sector opposed.<sup>19</sup> The *Sociedad Rural Argentina* (SRA) also withdrew its support for the Groups of Eight's efforts after the government conceded to exempt grains and oil seeds from a controversial VAT rate reduction in response to intense opposition from producers' associations (see Chapter 6, Part 2).<sup>20</sup> Big businesses with large labor costs accepted the corporate tax increases in

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<sup>14</sup>See also *Clarín*, Feb. 27, 1998: “El paquete tributario: el Ministro de Economía anuncio el proyecto que ira al congreso.”

<sup>15</sup>The sector simultaneously demanded a host of policies that would amount to state subsidies for agriculture (Sidicaro 198-199).

<sup>16</sup>The Group of Eight included representatives from the *Camara Argentina de Comercio*, ABRA (the bank association), the *Bolsa de Comercio*, the *Camara Argentina de la Construccion*, the *Sociedad Rural Argentina*, the *Unión Argentina de la Construcción*, and the *Unión Industrial Argentina*.

<sup>17</sup>*Clarín*, May 29, 1998: “Roque activó la alarma,” by Marcelo Bonelli.

<sup>18</sup>*Clarín*, June 13, 1998: “Crítico Documento del Grupo de los 8,” by Marcelo Bonelli. See also *La Nación* June 26, 1998 and *La Nación*, June 12, 1998: “Todos apuntan a Roque,” by Marcelo Bonelli.

<sup>19</sup>*Clarín*, March 7, 1998, *Clarín* June 21, 1998, *Clarín* June 26, 1998: “El Grupo de los 8 posterga críticas a la reforma fiscal,” by Alejandra Gall, *La Nación* June 26, 1998.

<sup>20</sup>*La Nación* June 26, 1998, *Clarín* June 23, 1998. From agriculture's perspective, the VAT concession constituted a “small triumph.” The VAT reduction on grains would likely have been more costly for agricultural than the new cross-sectoral taxes passed in 1998. In 2000, the minimum assets taxed raised 173,000 pesos from the agricultural sector (AFIP 2001), whereas reducing the VAT on grains—a sector-specific measure—could have cost agriculture up to twice as much. Representatives from the producers' associations asserted that although they opposed the assets tax and interest tax, the differential VAT reductions were the most worrisome measures for the agricultural sector (*La Nación* July 9, 1998, Former SRA 2006, author's interview).

light of the fact that they would benefit from the eventual reduction of employers' payroll taxes. The controlling owners of the Argentine multinational Techint, for example, publicly announced their support for the tax reform package.<sup>21</sup> The financial sector, which also received compensations,<sup>22</sup> responded to government pressure to refrain from public criticism of the reform.<sup>23</sup> The fact that the financial sector greatly benefited from the economic model and that many of the sector's recommendations on other policy areas had been enacted by the Menem administration probably contributed to the decision to tacitly accept the tax reform.<sup>24</sup>

These sector-specific benefits proved highly successful at preventing collective action, given the absence of a strong permanent encompassing association capable of enforcing a united front. The Group of Eight's document criticizing the tax reform was never made public, and it desisted from efforts at coordinating opposition by the end of June,<sup>25</sup> less than a month after the proposal had been announced and three months before the reform came to a vote in the lower house. The UIA, the industrial association deplored the banking and construction sectors' defections and continued to urge joint action against the tax reform, but to no avail.<sup>26</sup>

In the absence of coordination, the sectoral associations' independent efforts to oppose the reform achieved little influence. Meetings with Economy Ministry officials bore no results. Government technocrats explicitly pointed to the other tax reductions included in the reform package when business interests came to complain about the corporate tax increases; former Secretary of Treasury Guidotti (2006, author's interview) recalled that this tactic was generally effective. Meanwhile, the Economy Ministry ignored the complaints of the organizationally weak UIA. Guidotti (2006, author's interview) dismissed these concerns as the worries of groups within the UIA representing economically weak, noncompetitive, inward-oriented industries.<sup>27</sup> The Economy Ministry also ignored the SRA's complaints about the assets tax. According to Guidotti (2006, author's interview), both associations' demands reflected narrow sectoral interests and were viewed by the Economy Ministry as illegitimate.<sup>28</sup> In addition, both industry and agriculture were heavily involved in the types of tax avoidance and evasion that the two new taxes were intended to control (author's interviews: Guidotti 2006, Usé 2006).<sup>29</sup> After this stage of lobbying failed, the UIA, SRA and other associations presented very similar negative assessments of the new corporate taxes to the congressional Finance and Budget Committee. For the most part, legislators also ignored the business associations' complaints, with two minor exceptions. In response to the UIA's argument that the new taxes would hurt small businesses, legislators increased the exemption level for the assets tax and placed a cap on interest tax payments.

Given weak business cohesion, the cost of dividing and conquering business opposition was low relative to the revenue gains from the tax reform. For example, concessions to agriculture on the VAT rate reduction represented an annual revenue loss on the order of 150-200 million pesos (0.05% GDP)<sup>30</sup> in 1998.<sup>31</sup> By comparison, the assets tax and the tax on interest payments raised over 1,400 million pesos (0.51% GDP) in 1999. The payroll tax cuts, meanwhile, were left to the executive's discretion; the

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<sup>21</sup> *Clarín*, June 5, 1998.

<sup>22</sup> *La Nación*, June 26, 1998.

<sup>23</sup> *Clarín*, June 13, 1998, *Clarín*, June 26, 1998, *Clarín*, July 10, 1998.

<sup>24</sup> In addition, the corporate tax increases would have only a minimal impact on the financial sector.

<sup>25</sup> *Clarín*: March 7, June 13, June 21, June 26, and July 10, 1998.

<sup>26</sup> *Clarín* June 21, 1998: "Banqueros y constructores avalan el paquete y los industriales lo rechazan," by Mareclo Bonelli.

<sup>27</sup> The UIA also included more modern and competitive businesses (Etchemendy 2004).

<sup>28</sup> With respect to the UIA, for example, Guidotti (interview 2006) recounted: "the argument that the UIA had was ...keep high labor contributions on the privatized companies so that you don't need to raise taxes on us. But these type of arguments were very easy to counter. Because in fact they were arguing to place the burden on some other group of companies."

<sup>29</sup> The Economy Ministry used these arguments to de-legitimizing business opposition. For example, Guidotti remarked in the press: "cuando veo que algunos representantes de la industria dicen que sólo hay que bajar impuestos y no crear otros porque se desalienta la inversión, me parece que es un argumento vergonzoso. ...Con ese argumento lo único que se pretende es perpetuar los canales para la evasión." *Clarín*, May 17, 1998: "Polemica sobre evasión: Opina Pablo Guidotti."

<sup>30</sup> These figures come from newspaper articles for lack of official sources. The highest estimate of grains evasion was \$800 million dollars per year (0.1% GDP) (*La Nación*, June 27, 1998).

<sup>31</sup> *La Nación*, Dec. 18, 1997, *La Nación*, Feb. 15, 1998.

reform delegated authority to the president on this policy. This compensation for labor-intensive businesses therefore constituted an uncertain future benefit that would be phased in only as current revenue permitted. The cost of the corporate tax concessions introduced in congress was also minimal (author's interviews: Guidotti 2006, Usé 2006).

### ***Equity Appeals Forge Support in Congress***

While selective compensations allowed the Economy Ministry to manage business opposition, appeals to vertical equity helped to forge support in congress. Equity appeals were quite effective given legislators' cross-partisan tendency to support higher taxation of big business and multinational firms. On the one hand, equity appeals helped to align the PJ in favor of the new corporate taxes at a time when breaches of discipline on fiscal issues had become more frequent. On the other hand, equity appeals contributed to non-obstructionist opposition from the Radicals.

The Economy Ministry's central task with regard to congress in 1998 consisted of aligning PJ legislators behind the tax reform. The PJ held a majority in Congress, but party discipline eroded during Menem's second term. Eaton (2002: 132) traces declining PJ discipline to Menem's weakened influence over legislators' career paths during his second term in office, when he became a lame duck.<sup>32</sup> In fact, rebellion within the PJ compelled the Economy Ministry to remove a chapter on excise taxes from the 1998 reform package, and breaches of discipline occurred on the floor of congress with regard to VAT-broadening measures (Eaton 2002: 165).

On the matter of the new corporate taxes, however, the Economy Ministry successfully preserved discipline with the help of vertical equity appeals. On the one hand, the reform package was framed as shifting the tax burden from labor to capital (author's interviews: Guidotti 2006, Usé 2006). As Guidotti (2006) recounted:

They [the political wing of the administration] found a way to sell it as a Peronist reform ...the changes in the income tax and the [assets tax] and the inclusion of interest [in the tax] base... were seen as more taxation on capital and less on labor. In the end we had a couple of governors who traveled with us and explained the reform in political terms. Peron had a very old song "*combatiendo el capital*," this idea that you are pro-worker... they decided that this was consistent with a Peronist reform. That it was shifting a little bit the burden of taxation from labor to capital.

On the other hand, Economy Ministry officials emphasized that the new corporate taxes would target large businesses and tax evaders, groups that enjoyed little sympathy from legislators. For example, Secretary of Tax Policy Rodríguez Usé explained to reporters that the corporate assets tax: "Es para cerrar fuentes de evasión y elusión porque más del 50% de los grandes contribuyentes declaran no tener impuesto a las ganancias a pagar."<sup>33</sup> Guidotti quoted similar figures in the press as evidence of "una gran evasión en los sectores con mayor capacidad de pago" and stressed that the majority of the tax increases included in the reform package would target large tax evaders.<sup>34</sup> PJ deputy Lamberto subsequently made ample use of this argument during the debate on the bill in congress:

Tengo la tentación de leer una lista que contiene el nombre de las empresas más grandes del país que no pagan impuestos. Esto se parece mucho al régimen feudal, ...donde había nobles y vasallos: sólo estos últimos pagaban impuestos. Los nobles de la Argentina que figuran en esta lista que les exhibo no pagan impuestos. Si todas las bancadas nos acompañan con su voto, a partir de mañana se los podremos cobrar.<sup>35</sup>

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<sup>32</sup>Eaton (2002) observes: "By triggering a series of internal party struggles over who would succeed him as Peronist presidential candidate, Menem's reelection in 1995 ironically diminished his authority as party leader and reduced compliance with his reform proposals by Peronist legislators."

<sup>33</sup>*Clarín*, May 14, 1998: "Debate entre Terragno, Lamberto y Rodríguez Usé."

<sup>34</sup>*Clarín*, May 17, 1998: "Polemica sobre evasion: Opina Pablo Guidotti."

<sup>35</sup>Diario de Sesiones, Cámara de Diputados, 29ª Reunión, Continuación de la 10ª Sesión Ordinaria (Especial) Sept. 9, 10, 1998: 183.

Lamberto's list of firms that had not paid income tax in 1997, which he subsequently read aloud, included well-known multinationals such as Johnson and Johnson, Mercedes Benz, and Coca Cola, as well as Argentine firms like Petrolera Pérez Companc, Roemmers, and Papelera del Plata. The list created an uproar in congress and elicited a quick reaction in the press from the implicated firms, which asserted that they had not violated any tax laws.<sup>36</sup>

Equity appeals probably diminished opposition to the corporate tax increases from the UCR as well. The corporate assets tax was relatively uncontroversial (author's interviews: Guidotti 2006, Usé 2006), although the Radicals argued that small business would be affected along with large businesses; the PJ's agreement to increase the non-taxable minimum resolved the debate. The Radicals demonstrated greater opposition to the tax on interest—as discussed in Chapter 6, Part 1, they agreed with the goal of the tax but not the design of the tax—but tensions were again reduced thanks to modifications designed to ease the burden on small firms. Meanwhile, other elements of the reform that targeted big business, including transfer price regulations and sub-capitalization rules, were supported by the Radicals and Frepaso, their left-leaning coalition partners.<sup>37</sup> As Guidotti (2006, author's interview) recalled: "Everybody loved the chapter on transfer prices, because that was seen as revenue that would come at the expense of international companies. That was great, everybody loved it. ... everybody in congress. Nobody came to complain." Although the Radicals voted against the reform in congress, Economy Ministry officials maintained that they supported the reform in general and cooperated with the PJ to facilitate its approval:

Since this was a proposal from the PJ, the Radicals could not support it explicitly. So they would choose an argument against it, but then they would provide ...the quorum for the proposal to be passed. We had meetings ...with Machinea, with Alfonsín, on this to obtain support from them. And in the end they provided the support—without voting for it. But if you want to really oppose something, you don't provide the quorum. You force the PJ to have to bring all of the votes themselves, not only of their party, but also some of the provincial parties... So if the Radicals actually give you the quorum, things are much easier. ... And many of the economists that were associated and were essentially in the Radical party actually agreed with the reform. ...of course they wouldn't come out explicitly, but essentially they provided support to be able to pass it. (Guidotti 2006, author's interview)

### ***Comparison with Chile***

Whereas dividing and conquering through selective compensations proved highly effective in Argentina in the context of business's weak instrumental power, cohesion and partisan linkages made that strategy much less feasible for managing business opposition in Chile. For example, business maintained a united front against the Lagos administration's 2000 Anti-Evasion reform (Chapter 3, Chapter 4 Part 1). The executive ultimately negotiated many of the modifications to the proposed corporate tax base-broadening reforms with the specific sectors that were affected. However, each sector was in a stronger position to secure concessions thanks to solid support from the strong economy-wide peak association and collaboration from the right parties in congress. Consequently, Chile's 2000 reform secured only marginal corporate tax increases, whereas Argentina's 1998 reform produced a more significant, though still moderate, corporate tax revenue increase.

Due to business's partisan linkages, meanwhile, tax-side equity appeals in Chile tended to be less effective than in Argentina for facilitating passage of tax increases in congress. The right parties defended the tax interests of their core constituency—business and upper-income individuals.

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<sup>36</sup>*Clarín*, Sept 11, 1998: "Las empresas, en pie de guerra," *Clarín* Sept. 11, 1998: "Lamberto explica el significado de la lista de empresas que presentó en el congreso," by Ismael Bermude.

<sup>37</sup>Alianza Deputy Alessandro asserted: "De todos modos, hay un capítulo que es bueno y que nuestra bancada va a votar por la afirmativa. Se trata de los aspectos relativos al impuesto a las ganancias, que mejoran el sistema impositivo e introducen un sesgo progresivo. Me refiero a los precios de transferencia, que quedaban afuera de la percepción tributaria en la Argentina y que, si se los controla bien, es posible que empecemos a cobrar." *Diario de Sesiones, Cámara de Diputados*, 29<sup>a</sup> Reunión, Continuación de la 10<sup>a</sup> Sesión Ordinaria (Especial) Sept. 9, 10, 1998: 37.

Legitimizing appeals could occasionally win right votes in the Senate, but primarily when the tax issue at hand was salient in electoral politics (the tax benefit for stock holders, Chapter 4, Part 4) and/or enjoyed strong popular support (the copper royalty, Chapter 4, Part 3). In Argentina, which has no electorally significant right party, equity appeals mobilized cross-partisan support for corporate tax increases, and for tax increases targeted at upper-individuals as well.<sup>38</sup>

### **The 2003 Transfer-Price Reform**

The Kirchner administration's 2003 reform to control tax avoidance by export companies further evidences the pattern of weak business influence over corporate tax policy. In the absence of structural power or instrumental power, the major agroexport firms in Argentina failed to win any concessions or compensations, despite intensive lobbying directed at both the executive branch and congress. The executive branch ignored the exporters' demands, and as in 1998, equity appeals de-legitimated business opposition and mobilized cross-partisan support in congress.

### ***The Rationale for Reform: Controlling Tax Avoidance***

Just weeks after taking office in 2003, Néstor Kirchner's administration announced a series of reforms designed to reduce tax evasion and avoidance. The first of these reforms aimed to control a practice known as "triangulation of exports," which involved manipulation of transfer prices on the part of multinational corporations in order to reduce reported earnings in countries that imposed relatively high tax burdens and to increase reported earnings in tax havens or countries that imposed comparatively low tax burdens. The 2003 reform allowed the tax agency to make various presumptions regarding transactions between firms in Argentina and firms abroad and introduced other changes to transfer price regulations that increased export companies' corporate tax liabilities. This reform represented an additional step toward more effective tax agency regulation of transfer pricing and transactions involving tax havens that built on previous legislation passed by the Menem administration in 1998 and by the Alianza administration in 1999.

Article 2 of the 2003 reform specifically addressed the problem of tax avoidance by agro-exporters, who often shipped their goods through intermediary firms that were actually members of the same corporation located in nearby low-tax countries such as Panama and Uruguay.<sup>39</sup> According to the tax agency, the seven largest grain exporters in Argentina, which accounted for 60% of the volume of such exports, had avoided taxes amounting to at least 400 million pesos between 1997 and 2003. The income tax paid by these firms represented a mere 0.08% of the value of their exports.<sup>40</sup> The other articles included in the reform would affect export firms across sectors, including autos, pharmaceuticals, tobacco, and petroleum.<sup>41</sup>

### ***Chronicle of a Lobbying Failure Foretold: Weak Instrumental Power***

In the absence of business cohesion, partisan linkages, or favorable relationships with members of the executive branch, the exporters' prospects for obtaining modifications to the 2003 reform were quite poor. The fact that the exporters failed to win any concessions despite their fervent opposition to the reform thus comes as no surprise.

Given weak cohesion within the agricultural sector as well as among business more broadly, the exporters were left to fight against the reform largely on their own. Actors in the agricultural sector were organizationally fragmented and often had conflicting interests, as informants on all sides readily acknowledged (Chapter 6, Part 2). The agro-exporters did manage to mobilize some support from producers and other actors in the production chain despite these obstacles to collective action, but only after the reform had already been approved in the Chamber of Deputies. Forty different associations from

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<sup>38</sup>For example, tax increases targeted at upper-income individuals in a 1999 reform, including an emergency sur-tax on high incomes, secured support from both Peronists and Radicals.

<sup>39</sup>Abad quoted in Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Argentina, Oct. 4, 2006.

<sup>40</sup>*Clarín*, July 16, 2003: "La AFIP dice que las cerealeras eluden impuestos," by Pablo Kandel.

<sup>41</sup>Abad quoted in Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Argentina, Oct. 4, 2006: 27.

the agricultural sector signed a public statement denouncing the reform that was released two weeks after the vote in the lower house,<sup>42</sup> and producers' association representatives accompanied the exporters to the Senate Budget and Finance Committee hearings.<sup>43</sup> However, this delayed attempt at a united agricultural front against reform bore no results. The Senate passed the reform after a brief debate on the floor that lasted barely longer than an hour.<sup>44</sup>

The broader business community, moreover, tended to support the government rather than the exporters; concern over horizontal equity prevailed over business solidarity. For example, the *Asociación Empresaria Argentina* (AEA), an association representing some of the largest businesses in Argentina, expressed its firm support for the Kirchner administration's efforts to control evasion and tax avoidance. When asked about the measures designed to control triangulation of exports, an AEA informant responded:

Nosotros estamos de acuerdo con que hay que pararlo. Aunque a algunos no les guste acá, nosotros creemos que cualquier método de evasión, indirectas o directas, de los impuestos tiene que ser—también estos *tax shelters* y todas estas cosas—tienen que ser fuertemente controlados. ...Nos parece que no es bueno nada que facilite la evasión, nada. Ni para grandes ni para chicos. ...nosotros preferimos apoyar al gobierno en el combate a la evasión y en no hacer mayor problema en si deberían poner más énfasis acá, más énfasis allá. Lo importante es que lo hagan, y de a poco están avanzando. (AEA 2006, author's interview)

Even firms in other sectors that were directly affected by other measures in the 2003 reform did not issue public statements of support for the grain exporters or engage in other acts of solidarity.

In the absence of business cohesion, the executive's appeals to horizontal equity de-legitimated opposition from the exporters and contributed to the failure of their lobbying efforts. The Economy Minister and the director of the tax agency regularly denounced the exporters' tax avoidance. Lavagna (2006, author's interview) asserted that this strategy was highly effective in terms of managing opposition from the sector:

Cuando empezó la presión, lo que yo hice—dos o tres discursos—dí los datos de cuánto habían exportado estas grandes empresas, que era miles de millones de dólares, y cuánto habían pagado en los últimos cinco años. Y eso hizo que se callaron. Dejaron de hablar. ...las cifras de pago de impuestos eran mínimas... era tan grosero que optaron por callarse.

The exporters did in fact continue to publicly oppose the reform and lobby for concessions. However, informants from the sector admitted that the government's approach placed them in a difficult position. As one such informant recalled: "fue un momento político duro para las empresas del sector," (Exporter A 2006, author's interview).

Meanwhile, the exporters lacked informal ties to executive branch officials that could be mobilized in favor of the sector's interests. Not only did the Economy Ministry and the tax agency decline to take the exporters' complaints into account, but even the Minister of Agriculture, the exporters' most likely government ally, firmly supported the Economy Ministry's position (author's interviews: AFIP 2006 A, D, E). In fact, the Minister of Agriculture went so far as to repeat the government's accusations that the export firms had engaged in massive tax avoidance at a celebration commemorating the *Bolsa de Cereales*' 149th anniversary.<sup>45</sup>

Likewise, the exporters had little ability to win concessions in congress in the absence of partisan linkages or informal ties to a major political party. The associations representing the sector were given the opportunity to present their position to legislators in both houses of congress. However, like previous transfer price reforms in 1998 and 1999, the 2003 reform generated broad cross-partisan support. The

<sup>42</sup>*Clarín*, Aug. 27, 2003: "Exportadores y el agro vs. la AFIP," by Matías Longoni, *Clarín*, Aug. 30, 2003: "La Polémica Gobierno-Exportadores."

<sup>43</sup>*Clarín*, Sept. 13, 2003: "Proyecto de ley de ganancias: Un partido en el Senado."

<sup>44</sup>*Clarín*, Oct. 2, 2003: "El Senado aprobó una ley resistida por los exportadores," by Pablo Kandel.

<sup>45</sup>*Clarín*, Sept. 27, 2003: "La batalla de los impuestos."



UCR, the PJ, and the Socialists all voted in favor of the reform.<sup>46</sup> Ties between the agricultural sector and *Acción por la Republica* (APR), a small opposition party founded by Cavallo in 1998, were ineffectual for influencing the outcome of the legislation. APR Deputy Guillermo Alchouron, a former president of the SRA, opposed the reform, but his party's small block was in no position to secure concessions for the exporters.

Ultimately, the exporters achieved essentially no influence over the reform. Congress passed the legislation with basically no changes to the text sent by the executive branch. An export sector informant summarized the resounding failure of the lobbying efforts as follows:

El gobierno tenía un plan trazado y tenía un objetivo a cumplir, la verdad es que las presentaciones en tanto a la Comisión de Hacienda como las conversaciones informales en AFIP no fueron muy productivo, ellos siguieron con su método y no cambiaron una coma. Esa fue la realidad. El sector no logró tener una llegada. (Exporter A 2006, author's interview)

Thanks to the stronger transfer price regulations, the tax agency collected 2,700 million pesos of additional revenue from the income tax from 2003-2005 (Abad 2006, author's interview).

### ***The Exporters' Attempts to Invoke Structural Power Fail***

The exporters might have been able to influence the outcome of the 2003 reform if they had managed to generate concern regarding structural power among government officials or members of congress. The exporters' strategy for opposing the reform aimed to achieve precisely that goal. The exporters invoked structural power by arguing that the new regulations would destroy futures markets, reduce the value of exports, and depress prices for grains producers. For example, representatives from the *Bolsa de Cereales* prognosticated in the press: "El mercado de futuros seguirá inactivo. ...La reforma tendrá un impacto tremendo sobre el desarrollo del comercio de granos y perjudicará al productor, que pagará el índice de cobertura que tomarán los operadores ante la incertidumbre que introduce el nuevo sistema."<sup>47</sup> The oil industry association (*Cámara de Industriales Aceiteros de la Republica de Argentina*, CIARA) made similar arguments to legislators in the Budget and Finance Committee.<sup>48</sup> These actors warned that agricultural exports would fall by 860 million dollars per year (3% of the total value of all exports in 2003).<sup>49</sup> Had such threats been perceived as credible, the exporters may have achieved significant influence, given that grains and grain derivatives served as an important source of foreign exchange as well as a major source of revenue via export taxes in the aftermath of the 2001 crisis (see Chapter 6, Part 2).

However, the exporters' arguments did not convince either authorities in the executive branch or legislators in congress. The director of the tax agency and members of the team that designed the reform asserted that they had never been concerned about the possibility of negative affects on futures markets (author's interviews: Abad 2006, AFIP A 2006). Moreover, these informants emphasized that their assessment proved correct; futures markets quickly adapted to the new regulations and continued to function normally after the reform was implemented (author's interviews: Abad 2006, AFIP A, D, E 2006).<sup>50</sup> Legislators also proved largely immune to arguments invoking structural power, an outcome to be expected given the exporters' weak instrumental power in congress. The executive branch was able to maintain the upper hand with regard to legislators throughout the debate.

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<sup>46</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Aug. 13, 2003; Diario de Sesiones, Reunión No. 13, 5a. Sesión Ordinaria, Aug. 13, 2003.

<sup>47</sup>*Clarín*, Aug 16, 2003: "Impuesto a las ganancias: Del veranito a la tormenta."

<sup>48</sup>Raul Padilla, president of Ciara, asserted: "Lamentablemente creemos que el camino que se trata de elegir va en perjuicio de la producción y de toda la cadena," while another representative from the oil industry warned: "ésta ley ...va a romper el mercado de futuros." Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, July 2, 2003: 13, 14.

<sup>49</sup>*Clarín*, Aug. 25, 2003: "Crece la polémica con exportadores: Advierten que podría haber una caída de ventas externas."

<sup>50</sup>Informants from the agricultural sector also acknowledged after the fact that futures markets had not been harmed (author's interviews: Ravazzini 2006, Exporter C 2008). In addition, an SRA informant asserted that the reform had no perceptible impact on prices for producers (SRA A 2006, author's interview).

### ***Comparison with Chile***

The case of the 2003 reform highlights several differences between tax politics in Argentina and in Chile. First, lack of cohesion created very different dynamics in Argentina compared to Chile, where cohesion was strong. Argentina's grain exporters were left without allies from the broader business community in 2003; horizontal equity concerns prevailed over any incipient sense of business solidarity. In contrast, when multinationals faced similar reforms in Chile in 2000, the economy-wide business association came to their defense. Business class solidarity in Chile prevailed over concerns regarding horizontal equity. In the worst-case scenario for a reform-minded government, the economy-wide peak association would actively defend any particular sector threatened by a tax increase, as in the case of the 2005 copper royalty (Chapter 4 Part 3). In the best-case scenario, strategic reform design could dissuade the business community from actively mobilizing in support of the sector affected, beyond the usual declarations of solidarity in the press. This situation prevailed in the case of the 2008 reform to reduce the construction sector's special VAT credit, but only as a result of costly compensations for the broader business community included in the reform package (Chapter 4, Part 5).

Second, whereas in Argentina, business's weak instrumental power made it difficult to stimulate concern regarding structural power among legislators, in Chile, strong instrumental power—in particular, partisan linkages—gave business a greater ability accomplish that goal. Business in Chile generally was not able to convince the Finance Ministry that corporate tax increases would harm investment, but the right parties consistently responded to business's concerns. Moreover, the right parties' repetition and amplification of business's arguments that tax increases would harm growth and investment at times motivated more conservative Christian Democrats to question aspects of the executive's reform proposals.<sup>51</sup>

### **The 1992 Income-Tax Overhaul Proposal: An Exception Highlighting the Rule**

The Menem administration's failure to legislate a major overhaul of the income tax system proposed in 1991 serves as an exception that highlights the rule of weak business influence on corporate taxes. In this case, unusually broad and intense business opposition, circumstantial allies, and a fortuitous convergence of interests with legislators compensated for business's weak instrumental power.

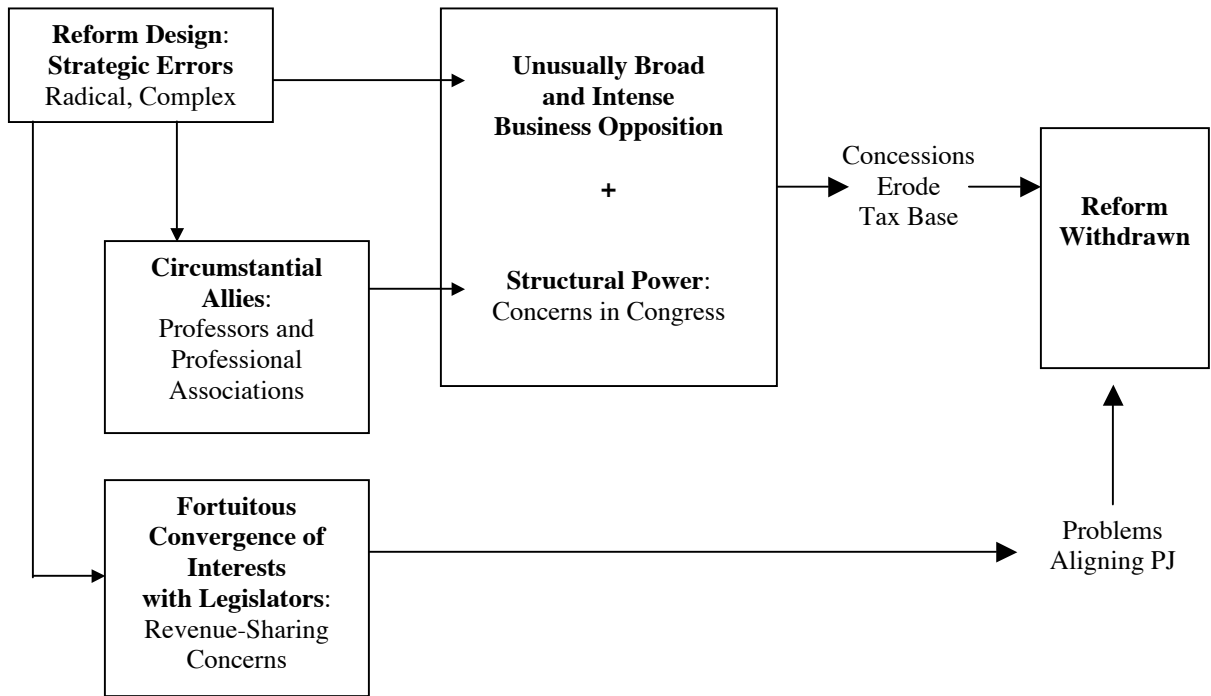
The radical and complex design of tax reform, which constituted a strategic error on the part of the executive, provoked unusually broad and intense business opposition, as well as unanimous opposition from respected academics and tax-professional associations. These academics and professionals, who wielded significant influence in Congress thanks to their technical expertise and status as independent, neutral actors, served as circumstantial business allies in the fight against the proposal. The academic and professionals' exposition of a wide range of economic problems that the taxes could cause augmented business's structural power in the legislative arena. To mitigate business opposition and address legislator's concerns, the executive was compelled to grant concessions that eroded the revenue-raising potential of the new taxes. Business also benefited from a fortuitous convergence of interests with legislators, who opposed the reform because revenue from the new taxes would not be shared with the provinces. Faced with a denatured proposal and insufficient votes in congress, the executive ultimately withdrew the reform.

The more conventional revenue-raising alternative subsequently proposed by the executive avoided the problems created by the prior proposal. In the absence of circumstantial allies or concerns regarding structural power in congress, business was in a weaker position to resist the reform. Business ultimately accepted the alternative with minimal complaints, and the proposal passed easily through congress. This tax increase generated a similar amount of revenue as the executive hoped to raise with the original proposal.

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<sup>51</sup>According to a former Finance Ministry informant: "Si la derecha realmente arma un escándalo, diciendo mire aquí esto realmente va a echar a perder la inversión y va a hacer una cosa persuasiva, van a haber parlamentarios de la concertación que van a entrar en duda... y el gobierno se va a ver obligado a negociar para asegurar, incluso sus propios votos," (Vial 2005, author's interview).

Figure 5.3: Causal Diagram: Demise of the IEPE



### ***The Rationale for Reform: A Radical Fix***

In 1991, the Economy Ministry announced a radical overhaul of the income tax system. The income tax as well as employers' social security contributions would be replaced by two new taxes: a tax on distributed profits (*Impuesto a las Ganancias Distribuidas, Dispuestas o Consumidas*, IGDDC) and a tax on primary surplus (*Impuesto sobre el Excedente Primario de las Empresas*, IEPE). The IEPE would consist of an 18% tax on the value added by the firm net of its labor costs. This tax would serve as a credit against the 30% tax on distributed profits.<sup>52</sup> Revenue from the IEPE would fund the soon-to-be reformed social security system. The reform package also eliminated a tax on financial services, and the executive promised to reduce the financial transactions tax in the near future.

From the executive's perspective, the proposed reform served a number of purposes. First, it would broaden the tax base. The corporate income tax base had been severely eroded over previous years due to accumulated losses generated by inflationary adjustments and more general economic duress. Replacing the income tax with the IEPE automatically eliminated the problems of accumulated losses.<sup>53</sup> The IEPE would also tax interest earnings, which were exempt from the income tax. This loophole provided multiple opportunities for tax avoidance and created a bias in favor of debt financing rather than capitalization, which orthodox economists viewed as distortionary (see Chapter 6, Part 1). Second, the Economy Ministry believed that the new taxes would be easier to control than the income tax and would thus help to reduce evasion.<sup>54</sup> Third, the new tax system would equalize the tax burden paid by capital-intensive firms and labor-intensive firms. The Economy Ministry viewed high payroll taxes as a burden on labor and a disincentive for creating employment, whereas capital-intensive firms benefited from various favorable tax treatments.<sup>55</sup>

<sup>52</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Dec. 25, 1991.

<sup>53</sup>*Clarín*, Jan. 28, 1992: "Habrán incentivos para concretar inversiones."

<sup>54</sup>*Clarín*, Dec. 6, 1991; see also Tacchi in Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Dec 25, 1991.

<sup>55</sup> *Ibid.*

Last but not least, the reform would generate additional net revenue amounting to 1.61% PIB (USD 2,467 million) per year.<sup>56</sup> The IEPE would be the primary revenue-raiser; it was expected to bring in 5.68% GDP (USD 8,700 million) per year,<sup>57</sup> a major increase compared to the income tax, which produced only 1.26% GDP in 1991 (DNIAF 2007). Revenue raised by the IEPE would compensate revenue loss from eliminating employers' payroll taxes.

### ***Strategic Errors: Radical Rather Than Incremental Reform***

The proposed income tax system overhaul constituted a radical and complex reform with major distributional consequences and a high, yet uncertain expected impact for capital-intensive businesses. Sub-Secretary of Public Revenue Tacchi, the intellectual author of the reform, openly acknowledged the distributional changes the reform would impose: “provocará una tremenda reacomodación en la estructura de costo de las empresas, dado que hasta ahora las empresas de capital intensivo tenían un beneficio mayor que las de capital humano intensivo.”<sup>58</sup> While the administration asserted that the reform would actually favor firms that pursued equity financing as opposed to debt financing,<sup>59</sup> business and independent professionals anticipated a major increase in the tax burden for the majority of capital-intensive firms. For example, a study by well-known economist Miguel Angel Broda claimed that while taxes paid by labor intensive businesses would decrease by 24%, those paid by capital-intensive firms would increase by 243%.<sup>60</sup> Other studies maintained that taxes paid by prominent firms traded on the stock market could increase six-fold.<sup>61</sup> Independent experts further noted the difficulty of anticipating what impact the tax reform would actually have in practice, given the radical, complex nature of the changes and the lack of any prior experience with the proposed taxes elsewhere in the world. While similar reforms had been proposed by the Reagan administration in the US in 1986, opposition from the Treasury Department compelled the administration to shelve the ideas.<sup>62</sup>

The radical design of the 1991 reform can be viewed as a strategic error on the part of the Economy Ministry that opened multiple fronts of conflict. More specifically, the reform provoked three problems that were absent in the case of the 1998 reform. First, the significant yet difficult to calculate impact of the reform provoked intense business opposition across sectors. This reaction is consistent with Ascher's (1989: 464) observation that business tends to react negatively “not just to expected losses but also to the risk of incurring costs that cannot be anticipated.” Given the radical nature of the reform, the compensations built into the package (reductions of other taxes) and appeals to horizontal equity (equalizing the treatment of capital-intensive and labor-intensive firms) did little to mitigate opposition from those sectors that would be most affected. Second, the reform elicited unanimous condemnation from independent tax professionals and academics, whose technical expertise and prestige allowed them to successfully challenge the government proposal. Unusually intense business lobbying in combination with condemnation by academics and professionals gave rise to the third problem—concerns among legislators regarding business's structural power. Had the executive pursued a more incremental and less complex reform, these problems could have been avoided.

### ***Broad, Intense Business Opposition***

The 1991 proposal provoked broader and more intense business opposition than less radical subsequent reforms. UCR deputy Raul Baglini (2006, author's interview), a long-term member of the Finance and Budget Committee, recalled: “Hay formas en las que uno se queja, diríamos, de ‘como me anda este zapato,’ o ‘el color de la cartera no me gusta,’ o ‘me está destruyendo el pie.’ Esto es ‘me está

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<sup>56</sup>*Clarín*, Jan. 28, 1992: “Cómo funcionará y qué efectos tendrá la nueva reforma impositiva,” *Clarín*, Dec. 27, 1991: “Prevén mayores fondos para el pago de jubilaciones.”

<sup>57</sup>*Clarín*, Dec. 27, 1991: “Prevén mayores fondos para el pago de jubilaciones.”

<sup>58</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Dec 25, 1991.

<sup>59</sup>“Capital propio-intensivo” in Tacchi's words. *Ibid.*: 0247-8.

<sup>60</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb 5, 1992: 34/40.

<sup>61</sup>*Ibid.*

<sup>62</sup>Reig, Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb 18, 1992: 4320.

destruyendo el pie.” Industry, finance, exporters, agriculture, and commerce all adamantly rejected the proposed tax system overhaul. Industry denounced that the IEPE “grava la inversión y la producción”<sup>63</sup> and warned that the tax’s “influencia e impacto sobre el nivel desempleo y de la inversión es desconocida.”<sup>64</sup> The UIA objected to the inclusion of exports in the IEPE tax base, the lack of tax credits for investments made prior to the reform, and taxation of interest from corporate bonds.<sup>65</sup> The financial sector also opposed taxation of interest from corporate bonds, warning that so-doing would reduce investment: “Si la Argentina gravaba esa fuente de ingreso de capitales, los inversores no harían mas que desviar su dinero ... a países donde no se gravan esos fondos, como el Uruguay. ... se corre el riesgo de liquidar de raíz un negocio que implica la inversión de miles de millones de dólares en el país.”<sup>66</sup> Exporters denounced the reform’s “lamentable sesgo antiexportador” and complained that the IEPE, whose taxable base included the value of exports, imposed undue and unrecoverable costs that would harm their ability to compete in international markets.<sup>67</sup> Agriculture, a capital-intensive, export-oriented sector, opposed the reform for similar reasons. Commerce, meanwhile, adverted that “La traslación del impuesto a los precios será inevitable.”<sup>68</sup>

In contrast to other cases, essentially all actors within the agricultural sector, including exporters and producers, opposed the reform. With regard to agriculture, Baglini (2006, author’s interview) recounted:

Me acuerdo de que todas las entidades del sector agropecuario, todas... porque en general la reforma impositiva no siempre puede distinguir un matiz entre las cuatro entidades básicas del sector agropecuario, con la Sociedad Rural, el CONINAGRO, la CRA, acá. Fue una cosa que ... ¿*Todos estaban de acuerdo?* Todos... totalmente aterrorizados todos.

CONINAGRO and the FAA, which represented cooperatives and small producers, complained about the technical complexity of the reform, objected to the inclusion of cooperatives in the IEPE tax base, and maintained that the reform would hurt indebted small and medium producers.<sup>69</sup> The SRA and CRA, which represented large producers, complained that the reform transferred the burden of the social security system to agriculture and objected to the IEPE’s treatment of exports:

El sector agropecuario ... está afrontando un terrible problema por la relación entre los precios internos y los precios internacionales. Hemos asumido que ese es el costo que debemos pagar para que haya estabilidad en el país, y lo estamos pagando. ... Entonces no se me ocurre cómo se puede pensar en gravar al sector exportador en un momento como este en que esta soportando una parte tan importante de la transformación económico.<sup>70</sup>

The SRA and CRA further maintained that the compensations for agriculture included in the reform—credibility of provincial property taxes against the IEPE—“no alcanza de ninguna manera a compensar el peso que injustamente se le está imponiendo.”<sup>71</sup> Agro-export firms, whose interests did not always coincide with those of the producers, also rejected the reform. CIARA announced its unequivocal opposition: “la reforma ... distorsiona los mercados y además genera imprevisibilidad comercial alterando el resultado de las operaciones ya finiquitadas.”<sup>72</sup>

Within industry, large firms and small business alike opposed the IEPE. Representatives from major business groups including Techint, Madanes, and Alparagatas expressed their concern by attending

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<sup>63</sup>Clarín, Feb. 13, 1992: “Industriales critican un proyecto.”

<sup>64</sup>Ibid.

<sup>65</sup>Clarín, Feb. 13, 1992: “Industriales critican un proyecto,” Clarín, Feb 25, 1992: “Ofensiva contra la reforma tributaria,” Clarín March 10, 1992: “Día D para la reforma,” Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb 12, 1992: 74.

<sup>66</sup>Clarín, March 11, 1992: “Los banqueros reclamaron por las obligaciones negociables.”

<sup>67</sup>Clarín, Feb. 28: “Idas y venidas por la reforma impositiva.”

<sup>68</sup>Clarín, Feb. 27: “UIA respalda los cambios.”

<sup>69</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb. 5, 1992: 224.

<sup>70</sup>Ibid: 392.

<sup>71</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb. 5, 1992: 391.

<sup>72</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb. 12, 1992: 373.

the Congressional Budget and Finance Committee meetings held to deliberate the reform.<sup>73</sup> Usually, only business association representatives attended such meetings. Meanwhile, the Consejo Argentino de la Industria, which represented small industry, complained that: “El IEPE discrimina a favor de las empresas de mano de obra intensivo, que son las más grandes.”<sup>74</sup>

### ***Circumstantial Business Allies: Academics and Professional Associations Reject Reform***

Business opposition benefited from circumstantial allies: academic tax experts and professional associations. Three professional associations, the *Consejo Profesional de Ciencias Económicas* (CPCE), *Colegio de Graduados en Ciencias Económicas* (CGCE) and the *Asociación Argentina de Estudios Fiscales* (AAEF),<sup>75</sup> along with professors with expertise in taxation from prominent universities, were invited to comment on the proposed reform in the House of Deputies Budget and Finance Committee. These independent experts unanimously rejected the reform on the basis of a wide range of considerations, summarized in Figure 5.4, that largely coincided with the objections raised by business. Accordingly, these circumstantial allies legitimated business’s complaints and augmented legislators’ concerns regarding business’s structural power. Whereas the grain exporters’ isolated lobbying efforts failed to generate any substantial concern regarding structural power with respect to the 2003 transfer price reform, support for business’s position from academics and professional associations in 1992 achieved precisely that goal.

Structural power was a prominent concern expressed by the academics and professional associations. Contrary to the Economy Ministry’s repeated assertions that the reform would encourage investment,<sup>76</sup> the experts asserted that the new taxes would actually hurt investment and could even threaten macroeconomic stability. The AAEF, for example, argued that the complexity of the new taxes and the difficulty of anticipating the actual tax burden would discourage foreign investment. All of the groups warned that foreign countries with which Argentina had signed treaties to avoid double-taxation would not grant tax credits for the IEPE, which could serve as an additional disincentive for foreign investors. Concerns over structural power were also expressed through warnings that the reform would hurt exports, by imposing substantial additional costs in a context of trade liberalization, an unfavorable exchange rate, and low international commodity prices.<sup>77</sup>

Experts also questioned the revenue-raising potential of the reform and its purported advantages for job creation. Not only was it difficult to predict the distributional affects of the reform on taxpayers, but it was also difficult to estimate how much revenue the reform would produce for the state, given the novelty of the new taxes, which had not been implemented in any other country.<sup>78</sup> Several experts expressed their opinions that the new taxes would generate less revenue than calculated by the Economy Ministry.<sup>79</sup> In addition, the CGCE argued that eliminating employers’ social security contributions would have no impact whatsoever on employment.<sup>80</sup>

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<sup>73</sup>*Clarín*, Feb. 13, 1992: “Industriales critican un proyecto.”

<sup>74</sup>*Clarín*, Feb. 27, 1992: “UIA respalda los cambios.”

<sup>75</sup>A fourth association, the CPACF (*Colegio Público de Abogados de la Capital Federal*), was also invited, but commented primarily on procedural aspects of the reform that I do not discuss here.

<sup>76</sup>See Tacchi in Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Dec 25, 1991. Juan Jose Llach, Subsecretario de Programación Económica asserted of the IEPE: “alienta la inversion... la empresa que más invierte va a pagar menos imps que aquella que no invierte.” *Clarín*, Feb. 22, 1992: “Llach pide la reforma.”

<sup>77</sup>Although the economy was not as reliant on exports to generate foreign exchange during Convertibility as opposed to after 2001, thanks to massive capital inflows to the financial sector, destroying the export sector certainly would have been problematic from a macro-economic perspective.

<sup>78</sup>AAEF, Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb. 18, 1992: 174.

<sup>79</sup>Massad, quoted in *Clarín*, Dec. 9, 1991: “La Recaudación se verá afectado.”

<sup>80</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb. 5, 1992: 41.

**Figure 5.4: Academic and Professional Association Concerns Regarding 1992 Reform**

<b>Concern</b>	<b>Sample Commentary</b>
<b>Structural Power</b>	
General / Explicit	<p><b>CPCE:</b> “un incentivo a la desinversión”†</p> <p><b>CGCE:</b> “no garantiza en absoluto un mejoramiento en cuanto a favorecer el crecimiento y la inversión,” “desalientan sin lugar a dudas a los inversores extranjeros y nacionales, porque atentan contra la credibilidad del sistema jurídico del país.” (Feb 5: 24)</p> <p><b>AAEF:</b> “su aplicación pone en peligro la estabilidad económica.” (Feb 18: 163)</p> <p>“Es publico que existe un manifiesto interés de inversores extranjeros para analizar alternativas de inversión en nuestro país. Esta reforma es un obstáculo en sus decisiones por dos motivos: primero porque no les resulta posible precisar sus efectos entre otras razones por el juego combinado de deducciones y pagos a cuenta entre distinto tributes y los mecanismos de tax credit de los diferentes países, y segundo, porque no lo visualizan como un sistema que habrá de perdurar y los preocupa la inestabilidad jurídica.” (Feb 18: 172)</p> <p><b>CI (Reig):</b> “la retención y reinversión de utilidades no se producirá,” (Feb 18: 232), “destruye la economía” (Feb 18: 401-2)</p>
Impact on Exports	<p><b>CGCE:</b> “hace una discriminación en contra de los exportadores... mientras que en el caso de las importaciones genera una ventaja comparativa frente a los bienes producidos en el país” (Feb 5: 44)</p> <p><b>CPCE:</b> “castiga ...al sector primario y al exportador” (Feb 5: 204/210)</p> <p><b>AAEF:</b> “el IEPE tiene un marcado sesgo antiexportador aumentando el costo argentino. Esto es particularmente incoherente con la predica actual y constante de nuestro presidente ... tratando de convencer a las autoridades de la necesidad de eliminar los subsidios que descolocan nuestros productos en los mercados internacionales” (Feb 18: 171)</p> <p><b>CI (Damonte):</b> “grava las exportaciones” (Feb 18: 314/230)</p>
Regional Integration	<b>All</b> denounce problems created by adopting a tax system radically different from the rest in the region.
Double-Tax Treaties	<b>All</b> denounce that foreign investors will not receive tax credits for the new taxes
<b>Uncertain Consequences</b>	<p><b>CGCE:</b> “un salto al vacío, dada su nula experiencia” (Feb 5: 44), “resulta difícil calibrar con precisión cuales serán los efectos” (Feb 5: 34/40)</p> <p><b>CPCE:</b> “no disponemos de legislaciones comparadas... no permite saber cómo se distribuye la carga” (Feb 5: 171)</p> <p><b>AAEF:</b> “ni el fisco sabrá cuanto podrá recaudar ni los agentes económicos cuales serán sus costos fiscales.” (Feb 18: 174)</p> <p><b>CI (Reig):</b> “una estructura fiscal totalmente novedosa, con caracteres no parangonables con ninguna otra forma de imp.” (Feb 18: 241)</p>
<b>Lack of Equity</b>	<p><b>CPCE:</b> denounces absence of non-taxable minimum. (Feb 5: 161)</p> <p><b>AAEF:</b> “total inequidad en la distribución de la carga tributaria” (Feb 18: 1164/170)</p> <p><b>CI (Reig):</b> 401-2: “No es de equidad” (Feb 18: 401)</p>

**CGCE:** Colegio de Graduados en Ciencias Económicas **CPCE:** Consejo Profesional de Ciencias Económicas

**AAEF:** Asociación Argentina de Estudio Fiscales **CI:** Cátedras de Impuestos (academics)

**Sources:** Actas, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb 5, 1992, Feb 18, 1992.

†Clarín, Feb 10, 1992. “Critican el proyecto de reforma fiscal: Colegio de Graduados de Ciencias Económicas.”

Thanks to their prestige, technical expertise, and status as disinterested actors independent of both business and the government, the academics and professional associations’ unequivocal presentations made a significant impact on the legislators presiding in the Budget and Finance Committee. As Baglini (2006, author’s interview) recalled:

Vinieron los tres mejores especialistas que había en la Argentina en Impuesto a las Ganancias... fue una masacre, pero una masacre! Nunca he visto una cosa igual. Sobre todo lo de Enrique Reig. Enrique Reig es un tipo sumamente respetado ... no

recuerdo una discusión de ese nivel, de pasar por la picadora de carne un proyecto. Realmente.

Indeed, Reig left no room for subtlety in his remarks. In direct response to Tacchi, who defended the IEPE and IGDD during the hearing as promoting efficiency and horizontal equity, Reig retorted: “No es de equidad y destruye la economía ... creo que [Tacchi] está completamente equivocado en material de política tributaria; debería remeditar este proyecto y retirarlo del Congreso.” Reig concluded his remarks by declaring: “No seamos un país subdesarrollado; mantengamos los buenos principios y las ideas sólidas y no aquellas que todavía nadie ha recogido.”<sup>81</sup>

According to Baglini (2006, author’s interview), the experts’ testimony played an important role in fomenting dissent against the reform in Congress. The Radicals, who controlled about a third of the seats in the lower house, resolutely opposed the reform. The UCR delegation in fact walked out of the final Budget and Finance Committee hearing on the 1992 reform without signing the committee’s bill recommendation (known as a report).<sup>82</sup> Only one deputy from the UCD, which tended to align with the PJ (Gibson 1996: 192), planned to vote in favor of the reform.<sup>83</sup> Given intransigent resistance from the main opposition party and minimal support from the UCD, the executive was forced to undertake the difficult task of seeking votes from the multiple provincial parties. Moreover, discontent arose regarding the bill within the PJ as well. The Peronist delegation requested that the Economy Ministry concede to several of the demands issued by business and the professional associations.<sup>84</sup>

### ***The Executive Grants Concessions at Significant Cost to Revenue-Capacity***

In order to mitigate business opposition and resistance in Congress, the executive granted sectoral concessions, just as in 1998. However, given the breadth and intensity of business opposition and stronger opposition from legislators, the executive lost control over the process. Legislators added additional modifications in the Budget and Finance Committee, and the accumulated concessions reached a significant cost, to the point that the revenue-raising capacity of the reform was all but destroyed.

The executive began to grant concessions shortly after the committee hearing at which the academics presented their analysis of the reform. The Economy Ministry’s first major concession, a non-taxable minimum of 3000 pesos for the IEPE, softened the impact of the reform on agriculture and independent professionals.<sup>85</sup> This concession, which arose out of a meeting between Cavallo and the PJ delegation, was interpreted as an attempt to obtain votes in Congress.<sup>86</sup> A day later, PJ deputy Lamberto, president of the Budget and Finance committee, announced additional deductions for agriculture and the possibility that industry would be allowed to deduct investments made after April 1991 from the IEPE.

During the political struggle to navigate the reform out of Committee and onto the floor of congress, the executive lost control over the contents of the reform to the PJ legislators. The PJ added a host of additional concessions to the bill in the Budget and Finance Committee; for example, various deductions and exemptions were granted to exporters, interest would be taxed at 12% rather than 18%, and corporate bonds issued prior to the passage of the reform would be exempt from the IEPE.<sup>87</sup> These concessions did not placate the Radicals, but they were probably important for maintaining unity within the PJ itself and for convincing three deputies from smaller opposition parties to remain present during the session. Without their presence, the PJ would not have met the quorum needed to report the bill.<sup>88</sup> The banking association’s subsequent complaints to Cavallo about the bill evidenced the extent of the

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<sup>81</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, Feb 18, 1992: 400-402, 423.

<sup>82</sup>Clarín, Feb. 27, 1992: “UIA respalda los cambios.”

<sup>83</sup>Clarín, March 11, 1992: “Clima enrarecido en Diputados.”

<sup>84</sup>Clarín, Feb. 20, 1992: “Cavallo admitió un mínimo para el IEPE.”

<sup>85</sup>Ibid., Clarín, Feb. 21. “Cambios en la reforma tributaria.”

<sup>86</sup>Clarín, Feb. 20, 1992: “Cavallo admitió un mínimo para el IEPE.”

<sup>87</sup>Clarín, Feb. 27, 1992: “UIA respalda los cambios,” Clarín, Feb. 27: “Cambios al Paquete Impositivo.”

<sup>88</sup>Clarín, Feb 27, 1992: “Tormentuosa aprobación de la reforma tributaria en Comisión de Diputados.”



changes introduced by the legislators: “Fuentes de ABRA indicaron ...que ni el mismo ministro está seguro de cuál es su redacción actual.”<sup>89</sup>

The extensive concessions granted by the executive and the PJ legislators eviscerated the bill’s revenue-raising capacity. Estimates of revenue to be generated by the IEPE fell from USD 8700 million dollars to only USD 765 million dollars, only 0.5% GDP.<sup>90</sup> Cavallo publicly acknowledged that the reform would not raise revenue just days after the final committee hearing on the bill and announced that the government would increase the VAT by two points in order to make up for the shortfall.<sup>91</sup>

With no net revenue at stake, the Economy Ministry had reduced incentives to fight for the reform. Cavallo continued to defend the package, maintaining that it would distribute the tax burden more equitably.<sup>92</sup> However, the limited revenue capacity of the IEPE contributed to his ultimate decision to withdraw the bill.<sup>93</sup>

### ***Fortuitous Convergence of Interests with Legislators***

Business’s crusade against the 1992 reform benefited from one final factor: a fortuitous convergence of interests with legislators representing provincial interests. Many legislators objected to the reform because it would redistribute revenue from the provinces to the central government.

Legislators in Argentina have strong loyalties to their provinces. Because governors and provincial party bosses have significant control over the political careers of politicians from their provinces (Eaton 2002: 135-141, Jones and Hwang 2005:121-125), they can influence how legislators from their provinces vote in the national congress. Eaton (2002), for example, demonstrates that conflicts of interests between governors and the president created breaches of discipline within the ranks of the PJ in the early 1990s, despite the fact that Menem’s authority within the party was quite strong.

The 1992 reform proved controversial with governors and hence with legislators in Congress because it proposed to replace a tax that was subject to automatic revenue-sharing, the income tax, with a tax whose revenue would be retained by the central government, the IEPE.

Cavallo unsuccessfully attempted to win over the governors by granting concessions relatively late in the game. A week before the bill was scheduled to be voted in congress, he announced that the provinces would receive 17% of the funds generated by the IEPE.<sup>94</sup> However, several PJ governors continued to resist despite the concession,<sup>95</sup> and the executive faced similar problems with legislators from provincial parties, who had fewer incentives to support the executive.<sup>96</sup> Thanks to opposition from the Radicals and most of the UCDE, the executive could not pass the bill without at least some support from the provincial parties.<sup>97</sup>

The difficulty of bringing the provincial legislators into line, along with the compromised revenue-capacity of the reform, motivated Cavallo to withdraw the bill before it could be debated on the floor of congress.<sup>98</sup> Had Cavallo allowed the IEPE and the IGDDC to continue through congress, these taxes most likely would have been defeated by an ample margin (Baglini 2006, author’s interview).<sup>99</sup> In fact, rumors circulated at the beginning of the session that the Radicals intended to withdraw from the chamber in order to prevent the PJ from securing the quorum needed to continue the session.<sup>100</sup>

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<sup>89</sup>Clarín, March 11, 1992: “Los banqueros reclamaron por las obligaciones negociables.”

<sup>90</sup>Clarín, Feb. 28, 1992: “Desde el 1 de marzo la tasa del IVA subirá del 16 al 18.”

<sup>91</sup>Ibid. The VAT increase was also intended to compensate planned reductions of the transactions tax and the assets tax.

<sup>92</sup>Clarín, Feb. 28, 1992: “Desde el 1 de marzo la tasa del IVA subirá del 16 al 18.”

<sup>93</sup>Clarín, March 11, 1992: “Cavallo resolvió dar marcha atrás con la reforma impositiva.”

<sup>94</sup>Clarín, March 5, 1992: “Comprometan reformas en el área fiscal y provisional.”

<sup>95</sup>Clarín, March 11, 1992: “Clima enrarecido en Diputados.”

<sup>96</sup>As reported in the press: “Las protestas arreciaban ...desde los legisladores provinciales y varios gobernadores (incluso peronistas) quienes advirtieron que sus legisladores votarían en contra del IEPE, porque el proyecto reducía los recursos netos para sus Estados.” Clarín, March 11, 1992: “Los banqueros reclamaron por las obligaciones negociables.”

<sup>97</sup>Clarín, March 10, 1992: “Día D para la reforma.”

<sup>98</sup>Clarín, March 11, 1992: “Cavallo resolvió dar marcha atrás con la reforma impositiva.”

<sup>99</sup>See also Clarín, March 11, 1992: “Cavallo resolvió dar marcha atrás con la reforma impositiva.”

<sup>100</sup>Clarín, March 12, 1992: “Cavallo apura un nuevo paquete impositivo.”

### ***A Successful Alternative: The 1992 Income Tax Reform***

After withdrawing the IEPE and IGDDC, the Economy Ministry proposed a less radical revenue-raising alternative: increasing the corporate tax rate from 20% to 30% and suspending the use of losses.<sup>101</sup> Although the amount of revenue at stake was essentially the same,<sup>102</sup> this alternative avoided the problems created by the prior reform proposal.

First, given that the alternative entailed less radical changes, and in the wake of the much celebrated demise of the IEPE,<sup>103</sup> business opposition was much more muted. The UIA, for example, disliked the suspension of losses, but agreed to accept the cost imposed for the sake of economic stabilization: “Ese era un derecho adquirido. Pero en un estado de emergencia es comprensible que se haya dejado de lado. Si el jubilado también sufre atengámonos a esto.”<sup>104</sup> Given how much worse the IEPE would have been for these sectors, it made sense for them to show support for the government’s decision by moderating their complaints regarding the alternative.

Second, the professional associations and academics approved of the new alternative. In fact, experts had explicitly recommended that the government restrict the use of losses rather than replacing the income tax. As Baglini (interview 2006) recalled: “Cavallo luego vino el día en que se trataba en el recinto y como si hubiera descubierto la pólvora esa día, vino con un proyecto que en realidad era todo lo que había aconsejado Reig.”

Given business’s greater acceptance and the independent experts’ approval of the alternative reform, as well as the absence of problems over revenue-sharing (the provinces retained the right to a fixed percentage of income tax revenue), the bill passed easily in congress.<sup>105</sup> The Radicals voted against the proposal, but without actively opposing it, and most of the UCDE and the provincial parties voted in favor with the Peronists.<sup>106</sup>

### ***Contrast with the 1998 Reform***

The 1998 reform, like the alternative 1992 reform, did not encounter the problems that undermined the proposed income tax overhaul, thanks to its more moderate design. Although the 1998 reform created two new taxes, their impact was neither as severe nor as unpredictable as that imposed by the IEPE, and the bill did not entail major revision of the tax system. Consequently, business opposition could be managed at a much lower cost in terms of concessions. While opposition arose from many different fronts, it was neither as broad nor as extreme as in 1992. Within the agricultural sector, producers and exporters were divided. The producers associations actively rejected the reform. But exporters had few complaints and remained aloof from the debate: “no hubo mucha participación del sector, no se sintió afectado,” (Exporter A 2006, author’s interview). Within industry, the most vociferous objections arose from small and medium sized firms. Large competitive firms that could better absorb the new costs moderated their complaints to a certain extent in order to show support for the executive’s broader economic model, from which they benefited, and/or because they supported the payroll tax reductions included in the reform (Guidotti 2006, author’s interview).

In addition, independent tax experts played a much less prominent role in the 1998 reform, and their assessments of the new corporate taxes were by no means as uniformly negative as in 1992. This difference can also be attributed to the less radical nature of the 1998 proposal. Independent academics did not take part in the debate, and only two professional associations, the AAEF and the CPCE, made

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<sup>101</sup>Businesses with losses were compensated with 16-year government bonds.

<sup>102</sup>The reform was expected to double the yield of the income tax (*Clarín*, March 13, 1992: “Habrá mayor recaudación”), which would produce a revenue increase of around 1.3% GDP.

<sup>103</sup>The vice-president of the SRA, for example, welcomed the news of Cavallo’s decision to withdraw the IEPE with the following words: “Fue un gesto muy noble. Habla de una humildad sin límites.” (*Clarín*, March 12, 1992: “Los empresarios, conformes.”)

<sup>104</sup>*Clarín*, March 12, 1992: “Los empresarios, conformes.”

<sup>105</sup>*Clarín* March 20, 1992: “Como quedó la reforma,” by Pablo Kandel.

<sup>106</sup>*Clarín*, March 18, 1992: “Diputados sancionaría hoy la reforma fiscal,” *Clarín*, March 19, 1992: “Visto bueno para la ley impositivo.”

presentations during the Committee hearings. While the AAEF opposed the corporate assets tax and the tax on interest,<sup>107</sup> the CPCE expressed relatively little concern.<sup>108</sup> The CPCE observed that the assets tax could serve the useful purpose of raising a significant amount of revenue and that the tax on interest legitimately sought to address the problem of excessive corporate indebtedness.<sup>109</sup> The CPCE also suggested that the interest tax would actually benefit small businesses.<sup>110</sup> No major concerns regarding the reform's impact on investment or other macroeconomic indicators were voiced. In contrast to 1992, therefore, circumstantial allies did not legitimate business's objections or create concern regarding structural power among legislators.

Finally, in the absence of the conditions that prevailed in 1992, opposition from legislators was much less intense. While the Radicals objected to the tax on interest and other elements of the 1998 reform, they collaborated with the PJ to allow approval of the legislation. The UCR signed the Budget and Finance Committee Report on the 1998 reform, albeit "in dissidence," and the party refrained from blocking the reform by preventing the PJ from obtaining a quorum on the floor. Negotiations with the governors over revenue-sharing issues decoupled from the debate over the tax-side of the proposal (Guidotti 2006b, author's interview). The executive secured the central government's right to retain the additional revenue generated by the tax increases, but the provinces did not face a net reduction in revenue as they had in 1992.<sup>111</sup>

### Conclusion

Corporate tax reforms in Argentina were more significant than in Chile due to business's much weaker instrumental power at the cross-sectoral level. Whereas business in Chile was highly cohesive at the cross-sectoral level thanks to strong organization and anti-tax ideology (Chapter 3), business in Argentina lacked cohesion due to weak organization and the absence of strong shared ideological views on taxation or any other sense of common identity. While business in Chile enjoyed partisan linkages to right parties with significant representation in Congress, no party in Argentina served business as a core constituency. Meanwhile, informal business ties to legislators from Argentina's two main parties did not create significant instrumental power due to institutional incentives that encouraged strong party discipline and shielded legislators from lobbying. Finally, whereas concertation with peak associations in Chile created incentives for the executive to avoid conflict with business on taxation, executive-business relations in Argentina followed a sector-specific logic that did not confer instrumental power at the cross-sectoral level. Sectors that enjoyed recruitment into government or informal ties to the executive branch pursued their own particular interests and did not defend common business interests. Figure 5.5 below summarizes these key differences.

Given weak structural power with respect to corporate taxation as well as weak instrumental power, business exerted little influence over the corporate tax agenda or the fate of proposed reforms. Thanks to weak business cohesion, the executive could divide and conquer business opposition to corporate tax increases with sector-specific compensations at relatively low aggregate cost. When tax reforms affected some sectors more than others or sought to control evasion and avoidance, support for the executive based on horizontal equity considerations trumped any sense of business-wide class solidarity. Meanwhile, in

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<sup>107</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, May 27, 1992: 15, 18.

<sup>108</sup>Acta, Comisión de Presupuesto y Hacienda, Cámara de Diputados, April 22, 1992: 3, 20.

<sup>109</sup>Ibid.: 17-18, 31 "...ha habido una serie de problemas entre filiales y casa matrices, lo que se ha llamado 'subcapitalización empresarial'—financiamiento a través de endeudamiento—sobre la cual las legislaciones van tomando medidas preventivas.... Desde el punto de vista macroeconómico es favorable que la Argentina introduzca algún tipo de castigo al endeudamiento y que tenga un equipamiento con respecto al financiamiento con inversiones de riesgo o de capital propio..."

<sup>110</sup>Ibid: 19. Ballesteros: "...en realidad se favorece indirectamente a la pequeña empresa. Esto es así porque la pequeña empresa es la que más dificultades tiene para recurrir al endeudamiento, en comparación con las medianas y grandes empresas que son las que en muchas oportunidades se financian con capital propio. Encarecer el endeudamiento o limitar el subsidio otorgado por el Estado a través del sistema tributario para ser financiado mediante endeudamiento, al sector que menos castiga es al de la pequeña empresa."

<sup>111</sup>In addition, the provinces had secured quite favorable overall revenue-sharing rules with respect to the central government in 1998 (Eaton 2005: 102).

the absence of partisan linkages, vertical equity appeals effectively consolidated support, or at least secured acquiescence, in congress. And business arguments invoking structural power had little affect. Business achieved more significant influence over corporate taxation only in 1992, when a radical reform proposal provoked opposition from other actors that served as circumstantial business allies. These dynamics contrast with corporate tax politics in Chile, where business tended to band together in defense of any sector or sectors threatened by tax increases, even if the reforms in question were designed to control tax avoidance, and vertical equity appeals were of limited success for winning votes from the right in Congress.

**Figure 5.5: Business Power and Corporate Tax Outcomes in Chile and Argentina**

	<b>CHILE</b>	<b>ARGENTINA</b>
<b>INSTRUMENTAL POWER</b>	<b>STRONG</b>	<b>WEAK</b>
<b>Cross-Sectoral Cohesion</b>	<b>Strong</b> Economy-wide peak association ( <i>Confederación de Producción y Comercio</i> ); Anti-tax ideology unites sectors	<b>Weak</b> Weak organization, no permanent economy-wide peak association; Less ideological views on taxes
<b>Relationships with Legislators</b>	<b>Strong</b> Partisan linkages: Right parties whose core constituency is business ( <i>Unión Democrática Independiente; Renovación Nacional</i> )	<b>Weak</b> No partisan linkages; Informal ties confer little influence: party-centered electoral incentives shield legislators from lobbies
<b>Relationships with Executive</b>	<b>Strong At Cross-Sectoral Level</b> Concertation with business associations creates incentives to avoid conflict with business on taxation	<b>Weak At Cross-Sectoral Level</b> Some sectors recruited into government or enjoy informal ties, but defend only their own special interests
<b>STRUCTURAL POWER</b>	<b>WEAK</b>	<b>WEAK</b>
<b>OUTCOME</b>	<b>MARGINAL REFORM</b>	<b>SIGNIFICANT REFORM</b>

## Chapter 6. Argentina’s Sectoral Tax Policy Successes and Failures: Variation in Business Power and Tax Outcomes

The previous chapter established that Argentine governments were able to significantly increase corporate taxation thanks to business’s weak structural power and weak instrumental power at the cross-sectoral level. This chapter examines how business power and tax policy outcomes differed at the sectoral level in Argentina. Business power varied significantly not only across sectors, but also across time and across tax reform proposals. Whereas business achieved little influence over corporate taxation, certain sectors enjoyed structural and/or instrumental power during delimited time periods that blocked or precluded tax reforms directly affecting these sectoral interests.

Part 1 examines three tax policy areas of particular concern to the financial sector: taxing interest earnings, expanding tax agency access to bank information, and taxing financial transactions. Part 2 analyzes two tax policy areas affecting a second major sector, agriculture: reducing the VAT rate on grains, and taxing agro-exports. From the early 1990s through 2008, policymakers considered implementing reforms in each of the five policy areas in order to raise revenue and/or to improve equity. Some of these policy areas were of interest to the executive branch policymakers across partisan affiliations and espoused economic principles (taxing interest earnings and expanding access to bank information), while other policy areas were primarily relevant for heterodox policymakers (taxing exports). Reforms in some policy areas remained off of the executive’s agenda during all or part of the time period analyzed. Reforms initiated in other policy areas failed at one time, but were successfully implemented at a later time. Figure 6.1 displays the five policy areas, their primary goals, and reform outcomes.

Business power explains most of the variation in the executive’s agenda and the fate of reform proposals over time and across these two major economic sectors and five policy areas. Revenue-raising capacity also helps explain why some reforms were proposed while others were not. For example, taxing interest earnings became less lucrative after 2001 and contributed to non-reform in this policy area. And in a few cases, executive reform strategies influenced the fate of proposals. While tax-side and/or benefit-side strategies usually facilitated reform, Part 2 examines a noteworthy case in which the executive’s strategic failures contributed to a major defeat in a policy area where the agricultural sector’s power had been quite weak (the 2008 export tax increase).

**Figure 6.1: Sectoral Tax Policy Areas, Goals, and Reform Outcomes, 1990s-2000s**

	Financial Sector			Agricultural Sector	
<b>Tax Policy</b>	Taxing Interest Earnings	Expanding Bank Information Access	Taxing Financial Transactions	Reducing VAT on Grains	Taxing Exports
<b>Goals</b>	Revenue, Equity	Revenue, Equity, Transparency	Revenue	Revenue	Revenue, Equity, Controlling Prices,
<b>Reform Outcome</b>	Off Agenda, 1990s-2007	Off Agenda, 1990s Implemented, 2006	Implemented, 2001 Maintained, 2002-2008	Failed, 1998 Implemented, 2002	Implemented, 2002 Increases, 2003-2007, Increase Reversed, 2008

### Part 1: Financial Sector Tax Politics

Two reforms with significant revenue-raising and equity-enhancing potential—eliminating Argentina’s unusual income tax exemption for interest earnings, and expanding tax agency access to information on bank deposits—remained for the most part absent from the executive’s agenda during the 1990s despite their recognized importance. The tax agency was able to obtain full access to deposit information in 2006, but the interest earnings exemption remained in place as of 2010. Meanwhile,

whereas both taxing interest earnings and expanding bank information access were viewed as infeasible, a financial transactions tax was implemented without difficulty in 2001 as the possibility of crisis began to loom on the horizon. Subsequent administrations maintained the tax after the crisis had passed. To explain when and why reforms were implemented in only two of these three tax policy areas, I analyze how investors' structural power and the financial sectors' instrumental power, as well as revenue capacity, varied across policy areas and over time.

Section I analyzes the issues of expanding tax agency access to bank information and taxing interest earnings. Structural power, predicated on a credible threat that investors would remove their savings from the banks, along with the financial sector's instrumental power, arising from recruitment into government and informal ties to the executive branch, kept reforms in each policy area off the agenda during the 1990s, with the exception of a few unsuccessful or short-lived reform initiatives. After 2001, investors' structural power with respect to bank information access and the financial sector's instrumental power both declined, due largely to the consequences of the 2001 crisis. The tax agency was therefore able to obtain complete and automatic access to bank information. However, investors' structural power with respect to taxing interest earnings remained strong and helped keep reform in that policy area off the agenda through 2008. The reduced revenue-raising capacity of interest earnings after the economic crisis also contributed to non-reform. This section includes a comparison with Chile in the policy area of common concern for governments in both countries—expanding tax agency access to bank information. In Chile, business's instrumental power kept reform in this policy area off the agenda through 2008, despite the absence of structural power.

Section II compares the financial transactions tax, an emergency revenue-raising measure proposed in Argentina in 2001, with reforms in the other two policy areas. In contrast to expanding bank information access and taxing interest earnings, structural power was weak with respect to taxation of financial transactions; this reform did not create an exit threat. Nor did the financial sector's instrumental power hinder reform; the banks did not oppose the tax, due to its minimal anticipated impact on bank deposits and the government's benefit-side reform strategies. After the crisis, executives maintained the transaction tax given its large revenue capacity; the financial sector did not actively lobby against the tax, nor did it enjoy sufficient instrumental power to have exerted influence in this policy area.

**Figure 6.1.1: Structural Power, Instrumental Power, and Financial Sector Tax Policy Outcomes in Argentina, 1990s-2008**

	Taxing Interest Earnings		Expanding Bank Information Access		Financial Transactions Tax	
	1990s-2001	Post-2001	1990s-2001	Post-2001	2001	Post-2001
<b>Structural Power</b>	<b>Strong</b>	<b>Strong</b>	<b>Strong</b>	<b>Weak</b>	<b>Weak</b>	<b>Weak</b>
<b>Instrumental Power</b> (Financial Sector)	<b>Strong</b>	<b>Weak</b>	<b>Strong</b>	<b>Weak</b>	<b>Strong But Indifferent To Reform</b>	<b>Weak</b>
<b>Revenue Capacity</b>	<b>Moderate</b> (0.3% GDP)*	<b>Low</b> (0.08% GDP)*	<b>Moderate</b> (0.5% GDP)†	<b>Moderate</b> (0.5% GDP)†	<b>High</b> (2% GDP)††	<b>High</b> (1.8% GDP)**
<b>Outcome</b>	<b>Reform Off Agenda</b>	<b>Reform Off Agenda</b>	<b>Reform Off Agenda</b>	<b>Reform Implemented</b>	<b>Reform Implemented</b>	<b>Reform Retained</b>

\*Lower end estimates. Author's calculations based on BCRA publications: *Información Diaria Sobre Depósitos y Obligaciones*; *Información sobre Tramos de Depósitos*; *Tasas de Interés por Depósitos*; *Balances Consolidados del Sistema Financiero*.

†Lower end estimates. Author's calculations based on AFIP 2005 and Alvaredo 2007.

†† Estimate of 6,000 million pesos per year (*Clarín*, March 24, 2001: "El Nuevo Gobierno: El Nuevo Impuesto a las Cuentas Corrientes"), as a percent of 2000 GDP.

\*\*Average revenue, 2004-07. DNIAF 2007

## I. Expanding Bank Information Access and Taxing Interest Earnings

### Raising Revenue and Improving Equity

Expanding tax agency access to bank information and taxing interest earnings, which are tax exempt in Argentina, both serve to increase taxation of upper-income groups, thereby raising revenue and improving equity. Tax agency access to bank information is crucial for controlling income tax evasion, as well as tax evasion more broadly, throughout Latin America. Taxing interest earnings would tap a concentrated income base and close a loophole that facilitates tax avoidance, which was particularly problematic in the 1990s.

### *Tax Agency Access to Bank Information*

Fighting evasion is critical for tapping Latin America's highly concentrated income tax bases, especially where top marginal personal income tax rates are already comparatively high, as in Argentina (35%) and Chile (40%).<sup>1</sup> Income tax evasion is a major problem even in these two countries, which have more advanced tax agencies than many others in the region. In both of these countries, income tax evasion is on the order of 40-50% (Alvaredo 2007: 15; Jorratt 2005, author's interview). Personal income taxes in most of Latin America affect only the top 10-15% of adults. Within this elite, only the wealthiest can evade taxes. Income taxes are usually deducted automatically from workers' wages, whereas wealthier individuals with non-wage income must file tax returns and thus have opportunities to under-declare assets. In Argentina, fewer than 3% of adults file tax returns. Yet because income is so concentrated, the revenue these taxpayers contribute is significant. In Argentina, revenue from income tax filers amounted to fully 1% of GDP in 2004.<sup>2</sup> Accordingly, by a very rough estimate, income tax evasion by the top 3% of income taxpayers cost the government 0.5% of GDP.

Tax agency access to bank information is crucial for detecting and deterring evasion (OECD 2000: 20, Bergman 2009). Information access allows tax agencies to detect undeclared assets by cross-checking tax returns against bank records. Requiring banks to routinely provide information on their customers' accounts and transactions is particularly useful in this regard. In addition, access to bank information discourages taxpayers from under-declaring their assets by increasing the perceived risk of being caught (Etcheberry 2005, author's interview, Bergman 2009). Where laws prevent bank information access, taxpayers can effectively hide large sums of money from the tax agency. Access to bank information helps control not only personal income tax evasion, but evasion of other taxes as well (AFIP A 2008, author's interview).

Laws vary worldwide in term of the types of information available to tax agencies and the conditions of access. In some countries, information is available only on a case-by-case basis; in others banks provide information in mass. In 2000, 19 OECD countries required automatic reporting by banks for at least some types of information, five maintained centralized databases accessible to the tax agency, and ten imposed no access limitations (OECD 2000: 36). A number of OECD and developing countries retain strict banking secrecy laws, but the worldwide trend is toward expanded access (OECD 2007).

Argentina's tax agency obtained access to bank information on checking and saving accounts in 1992 (*Dirección General Impositiva, Resolución 3211*: August 1992). This advance was made possible by an Alfonsín administration reform that exempted the tax agency from banking secrecy constraints (Ley 23.271, 1985). After 1992, the tax agency sought to expand its access to fixed-time deposits. Bank deposits grew dramatically following stabilization and implementation of Convertibility in March 1991, and time deposits contained over 65% of all funds in private banks by the end of 1995 (Figure 6.1.2). The tax agency suspected significant underreporting of money deposited in these instruments.

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<sup>1</sup>The Latin American average from 1999-2004 was about 29% (Sabaini 2006: 40).

<sup>2</sup>Author's calculations, AFIP 2005.

**Figure 6.1.2: Fixed-Time Deposits in Private Banks in Argentina, 1995-2000**

Source: BCRA: *Informe de Entidades Financieras*. Data for Dec. of each year.

	1995	1996	1997	1998	1999	2000
<b>Percent of Total Deposits</b> (Checking Accounts, Savings Accounts, Fixed Time Deposits, and Other Accounts)	65.2	63.5	65.9	67.5	69.7	71.7
<b>Percent of Ordinary Deposits</b> (Checking Accounts, Savings Accounts and Fixed Time Deposits)	67.2	65.6	68.1	69.4	71.5	73.7

### ***Taxing Interest Earnings***

Argentina's income tax legislation contains an exemption for interest earned from financial investments, such as savings accounts, time deposits, corporate bonds, and government bonds. In most countries, interest earnings are included in the personal income tax base. However, in Argentina, interest earnings were exempted from taxation in response to economic instability and hyperinflation in previous decades. Inflation rates exceeded interest rates on financial deposits, so that earnings were only nominal and did not constitute actual profits. The tax exemption for interest was renewed periodically by decree (Ehbrecht 2006, author's interview), despite the fact that Convertibility in the 1990s eliminated inflation and financial investments became highly profitable.

Because businesses are allowed to deduct interest payments on loans and corporate bonds from their corporate income taxes, the tax exemption for interest earnings has a double effect. Not only does the government forgo revenue from earned interest income at the individual creditor's end of the interest flow, but it also loses revenue from the corporate income tax at the debtor's end of the interest flow. In other words, the government subsidizes corporate debt. Consequently, businesses tended to distribute profits not as dividends, which are taxed, but as interest payments on corporate bonds, which are tax-free for the bondholder and tax deductible for the business.

Taxing interest earnings during the 1990s could have raised a non-negligible amount of revenue. A rough estimate suggests that taxing interest earned on bank deposits could have generated around 0.27% GDP in 1999.<sup>3</sup> Additional revenue would come from interest earned from corporate bonds; however, information is not available to estimate this amount. In addition, taxing interest earned on corporate bonds would have increased corporate income tax revenue not only by ending the subsidy for corporate debt, but also by controlling a common evasion mechanism known as an "*autoprestamo*," or "back-to-back," in which a business deposited funds in a bank and then withdrew those same funds in the form of a loan, deducting the interest paid from its corporate tax base. Partly due to this widespread practice, 50% of the 1,600 businesses classified as large contributors had not declared any taxable profits in 1998.<sup>4</sup>

Eliminating the tax exemption for interest earnings would have raised revenue primarily from upper-income individuals. First, because so few citizens are required to pay income taxes, exemptions, like outright evasion, by definition benefit upper-income individuals. Second, income tax rate structures are progressive, such that individuals in the upper tax brackets would experience a larger effective tax

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<sup>3</sup>Author's calculations based on the following BCRA publications: *Información Diaria Sobre Depósitos y Obligaciones*; *Información sobre Tramos de Depósitos*; *Tasas de Interés por Depósitos*; *Balances Consolidados del Sistema Financiero*. Methodology: I estimated the percent of interest paid to individuals from Central Bank data on percents of total deposits by sector and interest rates on time deposits and savings accounts. I then applied that percentage to the total amount of interest paid in 1999 reported by the Central Bank. I applied an average income tax rate of 25%, following DNIAF's current methodology for calculating the tax expenditure associated with the personal income tax exemption for interest earnings. DNIAF's methodology differs from mine by applying a correction for anticipated evasion of 50%. This approach should result in a significant underestimate of potential revenue, given that a tax on interest could be directly withheld by the banks, effectively eliminating all evasion (AFIP A 2006, author's interview).

<sup>4</sup>*Clarín*, May 17, 1998.



increase than individuals in the lower brackets if interest were taxed. Third, available evidence, though limited, suggests that interest earnings are highly concentrated.

Although there are no data available on the overall distribution of interest earnings by income brackets, tax agency statistics published in the 2000s show that the distribution of interest earned by the elite 3% of adults who file income tax returns was highly concentrated after the economy had recovered from the 2001 crisis.<sup>5</sup> In 2005, interest income declared by the top 11% of tax filers accounted for almost 50% of all interest declared (Figure 6.1.3). The top 0.7% of tax filers, who belong to the richest 0.01% of the adult population, declared 14% of all reported interest income.<sup>6</sup> Direct inferences cannot be drawn with certainty from this data about the distribution of interest earnings among citizens who do not file tax returns; however, the data are consistent with the hypothesis that interest earnings are concentrated in the hands of upper-income taxpayers in Argentina.

**Figure 6.1.3: Distribution of Interest Declared on Tax Returns in Argentina, 2005.**

Source: Authors' calculations based on AFIP *Anuario Estadísticas Tributarias 2006* (Table 2.2.2.1.9)

<b>Cumulative Percentile Among Tax-Filers</b>	<b>Percent of Total Declared Interest Income</b>
Top 51%	81
22%	59
11%	48
0.7%	14
0.1%	2

Central Bank statistics on the distribution of deposits by size provide additional indirect evidence that interest earnings are highly concentrated. Figures 6.1.4 and 6.1.5 show the distribution of fixed-time deposits held in US dollars in 1999 and fixed-time deposits held in Argentine pesos in 2005. These accounts respectively generated roughly 71% of all interest earned by individuals<sup>7</sup> in 1999 and 79% in 2005. In 1999, 56% of the funds were concentrated in only 13% of time-deposit accounts and were held in amounts totaling over 30,000 USD per account. In 2005, 51% of funds were concentrated in only 9.6% of time-deposit accounts and were held in amounts totaling over 50,000 pesos (approximately 17,000 USD) per account. Although the size of a given time deposit account need not be directly proportional to the owners' total income, it is reasonable to assume that individuals with the largest deposits fall within the top echelons of the income distribution. Because time deposit accounts are very concentrated, interest earnings, which are essentially proportional to the amount deposited, are most likely also highly concentrated among upper-income individuals as well.<sup>8</sup>

<sup>5</sup>Taxpayers receiving only wage income were not required to file income tax declarations until 2006; employers withhold taxes from their wages.

<sup>6</sup>Author's calculations based on AFIP 2005. Information on income sources from tax returns is not available from 1990-2001. Underreporting could potentially affect the distribution of interest income. However, economists often assume that evasion rates are constant across income brackets (Alvaredo 2007: 16). In addition, according to high-level tax agency informants, taxpayers have incentives to fully declare untaxed income in order to justify increases in net wealth (AFIP A 2008, author's interview).

<sup>7</sup>This figure refers to interest earned by individuals residing in Argentina. Residents abroad held an average of only 5% of funds in time deposits between 1994 and 2000 (Wilson 2008, personal communication).

<sup>8</sup>High-income individuals may own multiple accounts, but low-income individuals most likely do not. Consequently, the possibility of multiple account ownership should not affect the conclusions drawn above. If anything, correcting for multiple ownership should make the distribution more concentrated.

**Figure 6.1.4: Cumulative Distribution of Individual-Owned Fixed-Time Deposits Held in USD, 1999**

Sources: Author's calculations based on BCRA, *Información sobre Tramos de Depósitos* and *Información Diaria Sobre Depósitos y Obligaciones*

Size of Deposit (USD)	Accounts (% of total)	Amount (% of total)
Over 10,000	50	88
Over 30,000	13	56
Over 50,000	6.0	42
Over 100,000	1.9	29
Over 250,000	0.40	18
Over 750,000	0.10	12
Over 1,000,000	0.077	11

**Figure 6.1.5: Cumulative Distribution of Individual-Owned Fixed-Time Deposits Held in Pesos, 2005**

Source: Author's calculations based on BCRA, *Información sobre Tramos de Depósitos* and *Información Diaria Sobre Depósitos y Obligaciones*

Size of Deposit (Pesos)	Accounts (% of total)	Amount (% of total)
Over 10,000	50	90
Over 50,000	9.6	51
Over 75,000	5.0	39
Over 250,000	0.60	15
Over 750,000	0.10	6.7
Over 1,000,000	0.056	5.3

Whatever the actual distribution of interest earnings, policymakers, politicians, and the public did believe that the exemption for interest earnings primarily benefited Argentines at the very top of the income distribution. This perception was evidenced in interviews with public sector and private sector informants and legislators, as well as in newspaper articles.<sup>9</sup>

### **Structural and Instrumental Power Preclude Reform in the 1990s**

There is a broad consensus among Argentine economists, both orthodox and heterodox, that interest from financial investments should be taxed. Politicians across party lines also agree that interest should be taxed; complaints often arose in Congress that this exemption unfairly favored the rich. Moreover, policymakers within the Economy Ministry from both the Menem and De la Rúa administrations discussed the possibility of taxing interest earnings. However, the executive branch never initiated a proposal to eliminate the income tax exemption during the 1990s. Similarly, the tax agency was unable to obtain information on time deposits throughout the decade, despite active concern for strengthening the tax agency on the part of incumbent administrations, a cross-partisan consensus in support of anti-evasion measures, and repeated requests by the tax agency. Lack of progress in this policy area is especially remarkable given that access to time deposits required no formal reforms to existing legislation. Thanks to the Alfonsín administration's 1985 reform, which exempted the tax agency from banking secrecy restrictions, the tax agency in theory simply could have issued an administrative resolution requiring the banks to provide this information.

Reforms did not occur in these policy areas despite the otherwise highly propitious political context due to strong structural power, based on a widespread perception among policymakers and the financial

<sup>9</sup>See for example *Clarín*, Feb. 19, 2006: "El Gobierno ya trabaja en un proyecto de reforma impositiva," by Alcadío Oña; *Diario de Sesiones, Senado de la Nación, Argentina*, Dec. 28, 1999; author's interviews: Financial Sector A 2006, Baglini 2006, Di Gresia 2006.

sector that taxing interest earnings and/or granting the tax agency access to time-deposits would cause investors to withdraw funds from the banks en masse, due to the particularly high mobility and volatility of Argentine financial assets. In addition, the financial sector, which would suffer directly from that outcome, enjoyed significant instrumental power based on recruitment into government and informal ties to the executive branch. The combination of structural power and instrumental power created strong constraints that kept eliminating the income tax exemption for interest earnings and expanding information access off the agenda during the 1990s, but for a few largely unsuccessful initiatives.

### ***Investors' Strong Structural Power***

High mobility and potential incentives to relocate savings in response to reforms in these two policy areas created a credible disinvestment threat. Financial assets are always quite mobile; funds can be transferred electronically worldwide. But in Argentina, savings were also physically mobile. Financial centers in Uruguay are located close to Argentina's capital, making it especially easy for Argentines to move financial assets abroad.

In addition, the financial sector and policymakers in both the executive and legislative branches were genuinely concerned that giving the tax agency access to time deposits or taxing interest earnings would scare investors away from the banks. Informants from both the public sector and the private sector expressed the view that memories of economic instability made Argentines very sensitive to any changes in banking conditions. For example, a financial sector informant explained that Argentina's history of hyperinflation, economic crises, and bank failures that destroyed savings, as well as state interventions that froze and effectively confiscated bank deposits,<sup>10</sup> "generated a terrible sensation of uncertainty. And that sensation remains, that the banks are not so secure," (Wilson 2008, author's interview). Similarly, former Economy Minister Miceli (2008, author's interview) spoke of a "generalized psychosis produced by collective memories" of financial crises. Although it is difficult to objectively assess the hypothesis that Argentine investors were likely to withdraw deposits in response to reforms that might seem inconsequential in another context, this notion was quite pervasive.

The relative "shallowness" of Argentina's banking sector also provides evidence consistent with perceptions of significant risk in the financial sector, and/or the existence of other more attractive investment opportunities, that might dispose investors to relocate savings if the government were to eliminate the interest earnings exemption or grant the tax agency access to time deposits. The financial sector was less established in Argentina than in other countries of similar levels of development (Wilson 2006, author's interview).<sup>11</sup> The amount of money deposited in private accounts as a percent of GDP in Chile, for example, was roughly twice as big as in Argentina in the 1990s and in the mid-2000s (after recovery from the 2001 crisis) (Figures 6.1.6, 6.1.7).

Strict banking secrecy rules in Uruguay created additional incentives to relocate savings in response to reforms in these two policy areas, especially expanding tax agency access to bank information. Information about deposits and other financial operations in Uruguay was not accessible to the Argentine tax agency. Wealthy Argentines in fact regularly evaded taxes by registering assets to corporations constituted in Uruguay, and tax agency informants commonly referred to Uruguay as a "tax haven" (author's interviews: AFIP A, B 2006). A tax agency informant summarized the rationale against reform as follows:

If you put in place this informational regime, the only thing you're doing is forcing transfers to Uruguay, and you don't know anything about deposits in Uruguay. So business gets done in Uruguay, and Argentina loses capitalization and investment, all because of [the tax agency]. That was the argument—that we were going to scare away deposits. (AFIP A 2006, author's interview)

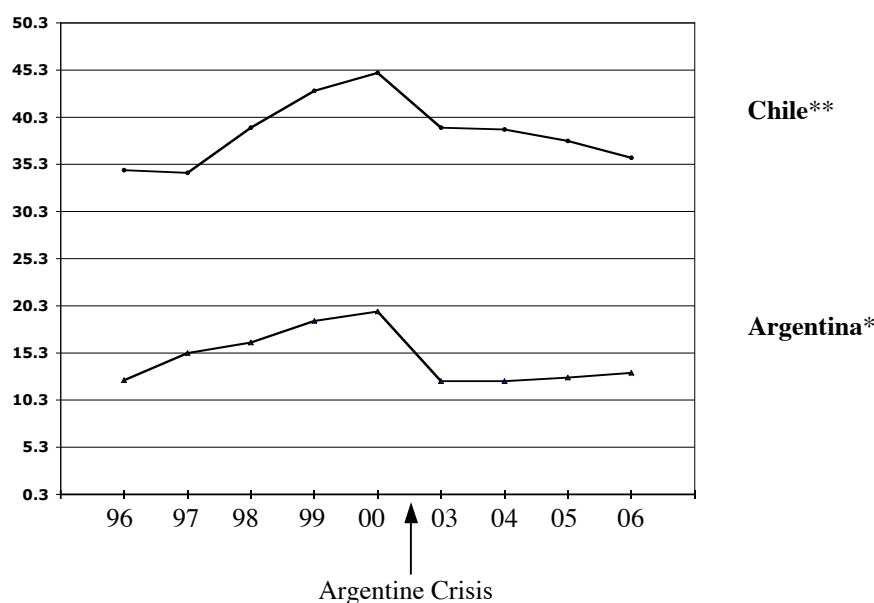
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<sup>10</sup>In an effort to contain inflation in 1989, the government decreed compulsory conversion of part of the savings in fixed-time deposits into government bonds with a ten-year maturation period.

<sup>11</sup>See also Acta de la Reunión de la Comisión de Presupuesto y Hacienda, May 20, 1998.

The disinvestment threat gave rise to strong structural power because of the significant potential impact on the financial sector and the economy more broadly. Time deposits, the accounts that would be most affected by both reforms, represented a large fraction of total deposits by value—an average of 70% from 1995 to 2000 (BCRA)—so massive withdrawals would have devastated the banks. And time deposits were in fact deemed to be the accounts most sensitive to changes in banking conditions; central Bank studies following the 1995 Tequila Crisis illustrated this empirical fact (Wilson 2008, author’s interview).<sup>12</sup> Moreover, the financial sector played a key role under Convertibility, which stabilized the currency and spurred high growth rates. Large quantities of foreign capital in the form of portfolio and direct investment were critical for sustaining the economy. Much of the money entering the country was invested in the financial sector, which channeled funds to the productive sector as well as the public sector. Because of the financial sector’s economic importance, large-scale time-deposit withdrawals could have had serious macroeconomic consequences.

**Figure 6.1.6: Private Sector Deposits in Private Banks in Argentina and Chile, %GDP**  
Corporate and Individual Accounts. Data are for December of each year.

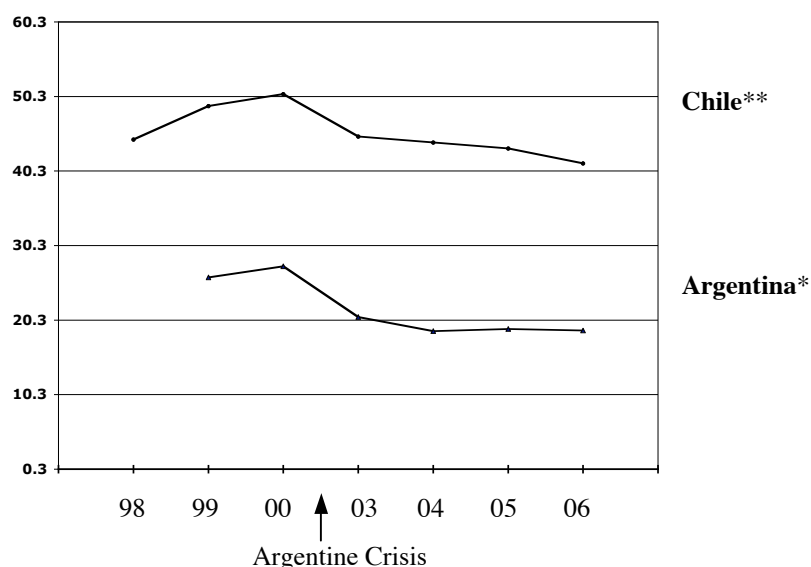


\*Sector privado no financiero y residentes en el Extranjero. Excludes: sector público no financiero, sector financiero. Source: BCRA, *Informe de Entidades Financieras*.

\*\*Sector privado. Excludes: sector público, sistema financiero, sector externo. Source: SBIF: *Revista Información Financiera*.

<sup>12</sup>According to financial sector informants, one reason for the particularly high volatility of time-deposits compared to other types of accounts is that investors are wary of relinquishing access to their savings for significant time periods, whereas the ability to remove funds at any time provides a greater sense of security (Wilson 2008, author’s interview).

**Figure 6.1.7: Private Sector Deposits in Private and Public Banks in Argentina and Chile, %GDP**  
Corporate and Individual Accounts. Data are for December of each year.



\*Sector privado no financiero y residentes en el Extranjero. Excludes: sector público no financiero, sector financiero. Source: BCRA, *Informe de Entidades Financieras*.

\*\*Sector privado. Excludes: sector público, sistema financiero, sector externo. Source: SBIF: *Revista Información Financiera*.

### The Financial Sector's Strong Instrumental Power

The perceived threat of reduced investment motivated the banks to reject reform in these two policy areas. Unlike corporate taxation (Chapter 5), tax agency access to bank information and taxing interest earnings were core interests for the banks—they feared they would lose depositors, which would have had a much greater impact on their profitability and viability than higher corporate taxes. The financial sector had sufficient instrumental power on its own to influence policy in these areas, even though other sectors did not have strong preferences on this issue.

The financial sector's instrumental power arose from recruitment into government and informal ties to executive branch officials. Financial sector leaders occupied important ministerial positions during the 1990s. For example, Roque MacCarone, president of the Argentine bank association ADEBA (*Asociación de Bancos Argentinos*) from 1982-1993, served as the Secretary of Finance during President Menem's first administration. In addition, orthodox economists from think tanks with ties to the financial sector such as CEMA (*Centro de Estudios Macroeconómicos de la Argentina*) were appointed to the Ministry of Economy and the Central Bank (Heredia 2004: 345).<sup>13</sup> President De la Rúa's Secretary of Treasury, Mario Vicens, also had close ties to the financial sector. Vicens had developed a strong relationship with the banking sector while he served as Director of the Central Bank in the 1980s and later as a private consultant (Wilson 2008, author's interview). In 2002 after leaving the government, he was elected president of the bank association ABA (*Asociación de Bancos de la Argentina*), which had formed from the merger of the international bank association and ADEBA in 1998. Recruitment into government, along with informal ties to cabinet members, gave the financial sector voice in policymaking within the executive branch.<sup>14</sup>

<sup>13</sup>See also *Página Doce*, May 19, 2002. MacCarone became head of the Central Bank in 2001.

<sup>14</sup>Technical expertise in orthodox economics, the language spoken by government technocrats, may also have contributed to the banking sectors' instrumental power. ADEBA's yearly conventions became important policy forums attended by government, as

Recruitment into government and informal ties to executive branch officials were partly a reflection of the financial sector's important role in the economic model promoted during the 1990s. Since government and financial sector interests coincided, it was natural for the executive branch to grant the banking association privileged access and to take seriously its concerns. As Menem's former Secretary of Treasury remarked: "the banks were a central voice," (Guidotti 2006, author's interview). As the deficit grew in the late 1990s, the financial sector became even more important for sustaining the economy and Convertibility. As a banking association informant explained: "En aquel momento, [el gobierno] se colocaba mucha deuda, necesitaban a los bancos para colocarla," (Wilson 2008, author's interview). This situation enhanced the financial sector's instrumental power. Former Secretary of Treasury Guidotti (2006, author's interview) observed: "The banking association was a relatively important association since financing for the government and for enterprises was very critical and the capital market was very complicated."

Instrumental power helped the financial sector influence policy on multiple fronts, including social security reform, Central Bank reform, strengthening capital markets, and other aspects of financial sector reform. As a long-time ADEBA official recalled: "The process of modernization was accompanied by the banks. In reality, we were very listened-to, not only on tax issues," (Ehbrecht 2006, author's interview). Similarly, Heredia (2003: 100) observes that "During the 1990s, the financial sector established itself as... one of the most powerful pressure groups."

Instrumental power helped keep access to time deposits and eliminating the income tax exemption for interest earnings off the agenda during the 1990s in two ways. First, instrumental power enhanced structural power; recruitment into government gave the financial sector ample opportunity to reinforce concerns within the executive branch that these reforms would reduce investment in financial instruments. Second, on rare occasion when structural power failed to keep reform off the agenda, lobbying the executive branch served as an alternate means for blocking reform, as the following section illustrates.

### ***The Aborted 1995 Initiative to Expand Bank Information Access***

In February of 1995 during the onset of the Tequila crisis, the Economy Ministry detected a large number of undeclared bank deposits while investigating cases of bank insolvency.<sup>15</sup> In the temporary absence of both the tax agency director<sup>16</sup> and the Secretary of the Treasury, the acting head of the tax agency issued an administrative resolution demanding information on all bank deposits in excess of \$12,000, including time deposits, for the purpose of detecting evasion.<sup>17</sup>

The financial sector reacted quickly against the resolution. According to an Adeba official, the timing of the resolution exacerbated incentives for investors to withdraw their deposits:

The sensation that a crisis was possible had not yet arrived... until in February of 1995, the tax agency announced that it would put in place an informational regime on time deposits. Something they had been studying for a long time. They had the bad idea of communicating it in February of 1995, and this provoked fear and provoked movement away from the banks... a small run... When they announced this, the first reaction was that everyone wanted to take their time deposits out of the banks. (Ehbrecht 2006, author's interview and translation)

Lobbying by the financial sector exacted a quick reversal of the tax agency resolution. Bank association representatives immediately contacted government officials, in particular Secretary of Finances Maccarone, former president of ADEBA, to express their opposition to the measure (Ehbrecht 2006, author's interview).<sup>18</sup> As a tax agency informant recalled, "there was pressure to back-peddle, a

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well World Bank and IMF officials. ADEBA's policy papers were seriously reviewed by the Economy Ministry (Heredia 2003: 97, Ehbrecht 2006, author's interview).

<sup>15</sup>Clarín, Feb. 15, 1995: "DGI salió a la caza de la plata negra."

<sup>16</sup>Clarín, Feb. 16, 1995.

<sup>17</sup>Cronista, Feb. 15, 1995 "Incrementan el control sobre los depósitos," Clarín, Feb 15, 1995.

<sup>18</sup>See also Cronista, Feb. 16, 1995: "La DGI debió anular la medida," and Clarín Feb. 16, 1995. The latter article reports that Maccarone had received "numerosas presiones por parte de los bancos para que los depósitos interbancarios quedaran excluidos

very strong position on the part of the financial system that they were not going to comply with the norm,” (AFIP A 2006, author’s interview). After meeting with Maccarone, Economy Minister Cavallo announced that the measure would be retracted. The tax agency had issued the resolution without previously informing or consulting Cavallo,<sup>19</sup> and he sided instead with the financial sector, whose arguments that the measure would exacerbate withdrawals from the banking system apparently convinced him. According to a press report: “In [the Ministry of] Economy, it was commented that the tax agency resolution had arrived at an unfortunate moment, with the public sensitized by the insolvency of several financial entities.”<sup>20</sup> Although legally nothing prevented the tax agency from obtaining time deposit information by administrative resolution, Cavallo had final authority on the issue since the tax agency was subordinate to the Economy Ministry. The resolution establishing the tax agency’s right to time-deposit information remained on the books for exactly one day.

### ***A Short-Lived Alternative to Eliminating the Exemption for Interest Earnings***

In 1998, the Economy Ministry proposed an alternative reform designed to tax interest earnings without eliminating the income tax exemption. Examining the political process surrounding this short-lived reform illustrates the strong constraints created by structural power with respect to this policy area, as well as the advantages and drawbacks of the reform strategy the government employed: obfuscating incidence to circumvent business power.

Although the perception that taxing interest earnings would lead to reduced investment in time deposits was widespread among policymakers in both the executive branch and the legislature, not all policymakers at any given time subscribed to this view. However, on occasions when structural power waned among one set of policymakers, structural power as perceived by other policymakers helped keep reform off of the agenda. For example, the Secretary of the Treasury and the Sub-secretary of Tax Policy during Menem’s second administration both felt that eliminating the income tax exemption for interest earnings would have at most a limited affect on depositors’ behavior (author’s interviews: Guidotti 2006, Rodríguez Usé 2006). Nevertheless, legislators, including members of the governing coalition, did perceive a significant disinvestment threat. Most importantly, PJ Deputy Oscar Lamberto, president of the Finance and Budget Committee, opposed including interest earnings in the personal income tax, based on the standard argument that depositors would flee from the financial system (Rodríguez Usé 2006, author’s interview).<sup>21</sup> Opposition from legislators arising from their anticipations of disinvestment helped dissuade Economy Ministry technocrats from proposing to eliminate the tax exemption.<sup>22</sup>

Although they did not pursue elimination of the income tax exemption, technocrats in the Economy Ministry believed that interest should be taxed, in order to raise revenue, close loopholes, and make the tax system more efficient from the perspective of orthodox economic theory (namely, by eliminating what amounted to a state subsidy for corporate debt). In order to circumvent obstacles created by strong business power, Economy Ministry technocrats devised an alternative reform proposal that employed the strategy of obfuscating incidence.

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de las exigencias de la DGI... El tema de los plazos fijos fue otro capítulo dentro de la presión de los bancos sobre Cavallo y su equipo.”

<sup>19</sup>*Cronista*, Feb.16, 1995.

<sup>20</sup>*Clarín* Feb. 16, 1995: “Cavallo obligó a la DGI a dar marcha atrás.”

<sup>21</sup>See also *Diario de Sesiones, Cámara de Diputados, Argentina*, Sept. 9, 1998: 6. Lamberto asserted: “En todas partes del mundo se captan ganancias sobre los intereses. En la Argentina, donde siempre hemos tenido una sensibilidad muy grande con los depositantes—porque tenemos un paraíso fiscal del otro lado del Río de la Plata y cuando tocamos los intereses los depósitos se fugan—ha sido casi imposible.”

<sup>22</sup>It is worth noting that the financial sector did not enjoy sources of instrumental power in congress. In fact, legislators tended to view the financial sector unfavorably. As Guidotti (2006, author’s interview) explained: “when they went to Congress, the banks had very little impact, because the banking sector was considered a very rich sector. The guys that had more appeal to politicians were the UIA [the industrial association], because of this idea of the small and medium enterprises,” that is, the UIA was perceived as representing smaller businesses, a constituency that received greater sympathy from legislators. Therefore, structural power was the critical factor that motivated legislators to oppose reform.

As part of the 1998 tax reform (Chapter 5), the Economy Ministry proposed a 15% tax on corporate interest payments and corporate debt (*Impuesto a los Intereses Pagados y el Endeudamiento Empresarial*, IPEE), which would tax interest at the level of the firm receiving credit, rather than the individual receiving interest earnings.<sup>23</sup> This strategic reform design exploited the principle of burden-shifting in order to obfuscate incidence. Economy Ministry officials argued that the new tax would have exactly the same incidence as including interest earnings in the personal income tax base, because the tax burden would be transferred from the debtors to creditors through interest rates. If interest were included in the personal income tax (PIT) base, banks would have to offer higher rates of return to their depositors, which they would compensate by charging higher interest rates on loans. Charging a tax on corporate interest payments would have the same effect: an increase in the net interest rate paid by firms. In practice, the impact of taxing financial interest, either with the IPEE or by including interest in the PIT base, would be distributed in some proportion between corporations and depositors through changes in interest rates (Guidotti 2006, author's interview).

The novel new tax was expressly intended to make taxation of interest earnings less visible to individual investors, including owners of time deposits, and hence less likely to motivate flight from the banks and less likely to stimulate opposition from the financial sector and legislators, who perceived structural power to be strong. Obfuscating incidence in this manner proved highly effective in these regards. Although the bank association did complain to Congress that the tax would raise the cost of credit and hence discourage investment,<sup>24</sup> the financial sector accepted the reform with minimal resistance (Guidotti 2006, author's interview).<sup>25</sup> To win the sector's acquiescence, Economy Ministry officials explicitly presented the reform as an alternative to eliminating the exemption for interest in the personal income tax: "les decíamos a ellos 'Ojo, pensamos esto [el Impuesto al Endeudamiento] porque lo que antes pensábamos era directamente eliminar las exenciones,' que, por supuesto, ellos nos dijeron 'Sí, eso es mucho peor que el Impuesto al Endeudamiento,'" (Rodríguez Usé 2006, author's interview). The IPEE alternative also diminished resistance from governing coalition legislators. In fact, few legislators actually understood that the IPEE would tax interest earnings, despite repeated explanations by the technocrats who designed the reform.<sup>26</sup> The new tax was approved by congress in 1999.

Despite success at circumventing structural power and precluding opposition from the financial sector, obfuscating incidence entailed tradeoffs that contributed to the short duration of the IPEE. These tradeoffs took the form of uncertainty regarding the actual incidence of the tax. The Menem administration's assertion that this novel tax was in practice equivalent to including financial interest in the personal income tax generated significant controversy. Economists associated with the Radical Party did not believe that the perfect market assumptions underpinning this theory of incidence were satisfied in practice. Machinea (2007, author's interview), who served as President De la Rúa's Economy Minister, recalled: "Mi discusión con ellos es que los mercados financieros en Argentina no eran tan perfectos y por lo tanto... el impacto iba a ser mucho mayor sobre los tomadores de créditos que lo que sería un impuesto sobre los depósitos." The Radical economists felt that the IPEE imposed an undue burden on small

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<sup>23</sup>This tax was modeled on the Comprehensive Business Tax proposed by George H.W. Bush advisors in the early 1990s. According to the Bush advisors' proposal, investors would pay no tax on interest or dividends, but corporations would not be able to deduct either interest or distributed dividends from their income taxes. Thus, interest and dividends would be taxed at the firm level, and all business income would be taxed at a single flat rate. ([www.dkosopedia.com](http://www.dkosopedia.com))

<sup>24</sup>Acta de la Reunión de la Comisión de Presupuesto y Hacienda, Cámara de Diputados, Argentina, May 20, 1998.

<sup>25</sup>Economy Minister Cavallo's proposed 1992 income tax system overhaul, which had to be withdrawn due to widespread opposition from the private sector (see Chapter 5), also would have taxed interest at the level of the corporation. In contrast to the 1998 reform, however, the 1992 initiative did generate intense opposition from the financial sector. The fact that legislation promoting corporate bonds had been passed just one year earlier (Law 23.962) in an effort to stimulate capital markets probably accounted for the difference in reactions from the financial sector. In 1992, these corporate bonds had not yet been established as a major financing alternative for firms, and both the UIA and the banking sector argued that taxing interest, even at the firm level, would discourage investors from purchasing these instruments. On that occasion, the association of foreign banks argued that in response to Cavallo's reform, "los inversores no harían mas que desviar su dinero, como ya lo están haciendo, a países donde no se gravan esos fondos, como el Uruguay," (*Clarín*, March 11, 1991).

<sup>26</sup>As discussed in Chapter 5, Economy Ministry technocrats cultivated active support for the IPEE within the PJ by framing it as a tax on capital, which appealed to traditional Peronist values (Guidotti 2006, author's interview).



enterprises, which already faced much higher interest rates than big firms (author's interviews: Machinea 2007, Sabaini 2006). Consequently, the De la Rúa administration gradually phased out the IIPEE when it came to power in 1999, leaving financial interest untaxed once again.

Like the Menem administration technocrats, De la Rúa's economic team firmly believed that interest earnings should be taxed, despite their disagreement regarding the IIPEE (author's interviews: Machinea 2007, Sabaini 2006). In internal meetings, the new Economy Ministry team discussed addressing this issue as part of the 1999 tax reform package, which was intended to control the growing budget deficit and sustain Convertibility. Sub-Secretary of Tax Policy Gómez-Sabaini made at least one public statement expressing his opinion in favor of eliminating the income tax exemption.

However, concerns within the administration regarding investors' structural power, along with opposition from the financial sector, whose instrumental power remained strong, ultimately deterred the Economy Ministry from initiating the reform. Gómez-Sabaini's statement aroused immediate opposition from Secretary of the Treasury Mario Vicens, whose opinion coincided with the views of the banking sector, which he would later represent as the head of ABA. Moreover, the President himself subscribed to the argument that eliminating the tax exemption could motivate depositors to remove their money from the banks. Finance Minister Machinea ultimately agreed that incorporating interest earnings into the income tax as part of the 1999 tax reform package was not feasible given the negative potential economic consequences of the measure:

We depended very much on the financial markets, because we had to obtain \$20,000 million to finance the debt payments. That was the problem, our Sword of Damocles all of the time. ...With any strong noise in the markets, we were very weak, because we needed a lot of resources to finance the debt... When we assumed the government, we had only 45 days of money to pay the debt... So this tax on [interest from] deposits, which was quite reasonable—we had discussed it internally, we thought that at some point it would have to be done—in this context of such weakness, such vulnerability, no. It was not reasonable. (Machinea 2007, author's interview and translation)

After securing approval of the 1999 tax reform, which required significant political capital, Machinea felt the administration was not strong enough politically to bring up the issue of taxing interest earnings, setting aside the larger problem that De la Rúa had expressed adamant opposition to the idea (Machinea 2007, author's interview).

Just as some government technocrats during the 1990s were relatively unconcerned regarding the economic consequences of eliminating the income tax exemption for interest earnings, various blocks in congress occasionally agitated in favor of this reform. For example, Peronists, who held a majority in the Senate during De la Rúa's presidency, actually amended the 1999 tax reform package to include this measure as a replacement for other tax increases in the bill that they opposed. Whereas Peronist legislators had viewed this measure as infeasible during the Menem administration due to concern over investment, they now extolled its virtues from the point of view of equity. Peronist Senator Gioja declared: "Creo que es hora de que... se revierta el carácter regresivo que hoy muestra nuestra estructura impositiva... no estamos proponiendo un impuesto al plazo fijo sino que las rentas financieras paguen impuestos como cualquier otra. Si paga la renta al trabajo, cómo no va a pagar la renta financiera."<sup>27</sup> However, Radical legislators, who had themselves advocated taxing interest earnings on previous occasions during Menem's presidency (Baglini 2006, author's interview), rejected the modification in the House of Deputies, in accord with the governing administration's concerns regarding the potential impact on bank deposits.

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<sup>27</sup>Peronist Senator Maya added: "Observamos en el panorama económico que desde hace mucho tiempo existen sectores de la economía, como el sector financiero y el de los altos niveles de recursos, que tienen ingresos muy importantes. Y pensamos que lo conveniente era eliminar exenciones; no crear nuevos impuestos. Con una sola exención nosotros logramos casi el doble de la recaudación anhelada por el gobierno en esta materia. Concreto lo que es parte del dictamen en mayoría, que consiste en hacer tributar o eliminar la exención que existe sobre los intereses de los plazos fijos..." Diario de Sesiones, Senado de la Nación, Dec. 28, 1999.

These shifting positions illustrate two features of the debate over taxing interest earnings in Argentina. First, there is a strong cross-partisan consensus that eliminating the exemption for interest earnings is normatively appropriate, setting aside the issue of whether or not doing so is feasible in practice. Second, as observed by longtime Radical legislator Raul Baglini (2006, author's interview), positions on whether or not this reform should be undertaken at any given time tend to correlate with whether legislators belong to the governing coalition or to the opposition, rather than party membership:

Cuando uno está en la oposición dice “¡Qué esperamos para gravar los depósitos a plazo fijo de esos tipos que tienen millones..! y vamos, y los grandes aplausos, una cosa bárbara. El tipo que está del otro lado, el que está sentado en el Gobierno, le tiembla la mano cuando piensa mire, mañana tenemos una corrida bancaria y es posible que este—usar reservas, diríamos, para darle redescuento.

Accordingly, sensitivity to potential disinvestment and hence perceptions of structural power have tended to be greater among members of the government than members of the opposition.

### **Bank Information Access Post-2001: Weak Structural and Instrumental Power Facilitate Reform**

Structural power with regard to expanding tax agency access to bank information declined significantly in Argentina after 2001. The financial sector's instrumental power declined as well. In the absence of constraints from business power, the tax agency was finally able to obtain access to time deposits. The 2001 economic crisis and increasing oversight of the financial system in response to international pressures drove these changes in structural and instrumental power that were necessary for reform.

Argentina's 2001 economic crisis undermined structural power by reducing the vulnerability of the economy and the financial sector to any potential disinvestment that the reform might have provoked. From a macroeconomic perspective, the financial sector played a much less important role in the economy after the crisis and the ensuing demise of Convertibility. The massive run on the banks leading up to the crisis and the freezing and subsequent devaluation of deposits that remained in the banks drastically reduced the relative size of the sector. Deposits in public and private banks as a percent of GDP fell from 28% in 2000 to an average of only 19% from 2003 to 2006 (BCRA); deposits in private banks decreased from 20% to 13% of GDP (Figure 6.1.8). While governments sought to strengthen the financial sector, maintaining a high value of deposits was much less critical for stability in the post-Convertibility era. Further, from the financial sector's perspective, time deposits were less important. After the crisis, the value of funds in time deposits relative to other accounts declined significantly, partly because much lower interest rates made time deposits less attractive investment instruments, and partly because customers preferred ordinary savings accounts with unrestricted access, given their loss of confidence in the banking system. Time deposits as a percent of the total value of deposits in private banks dropped from an average of 68% from 1996-2000 to only 42% from 2003-06 (Figure 6.1.9).<sup>28</sup> Additional time deposit disinvestment would thus have had a much smaller impact not only on the economy as whole, but also on the banks, compared to the pre-crisis era.<sup>29</sup>

In addition, international pressure to fight money laundering following the terrorist attacks in the US indirectly weakened incentives to relocate savings in response to reform. Argentina was adopting many measures to fight money laundering, and in this context, the banks perceived that their customers would be much less likely to react negatively if the tax agency obtained time deposit information. As an ADEBA informant asserted:

Por la crisis de Tequila, la gente estaba más sensibilizada.... Ahora ya la cosa es distinto. ...Todo el mundo tiene consciencia que hay un control, la AFIP controla las

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<sup>28</sup>Time deposits as a percent of the total value of deposits (including savings accounts, checking accounts, time deposits and other accounts) in public and private banks dropped from 72% in 2000 to an average of 44% from 2004-2006. Author's calculations, BCRA, *Informe de Entidades Financieras*.

<sup>29</sup>For example, if the banks had experienced a catastrophic withdrawal of time deposits in 2005 equivalent to the same percent decrease as occurred over the course of 2001 (49%), total funds in the private banks would have decreased by only 21%.

operaciones que se hacen en el circuito bancario, mas que los bancos por todo que sea lavado de dinero, hacen un seguimiento de los clientes. Me parece que es otra situación, completamente distinto. La gente esta cada vez más conciente que si va a hacer una operacion en un banco, hay un monitoreo. (Ehbrecht 2006, author's interview).

In other words, investors anticipated that their financial operations would be monitored, if not to control tax evasion, then to control money laundering. Therefore, on the one hand, the new context of international concern over money laundering legitimated access to deposit information—investors were less likely to interpret tax agency requests for this information as a sign that their savings might be insecure. And on the other hand, investors who did not want the tax agency to have information about their assets probably would not have deposited large sums of money in the financial system after 2001. The banks' clientele was thus less likely to include people who would move their money to Uruguay in response to expanded information access.<sup>30</sup> Figure 6.1.10 summarizes how the economic crisis and international pressure to fight money laundering reduced structural power after 2001, compared to the 1990s.

The banks' instrumental power also declined after the 2001 crisis. Recruitment into government ended with Convertibility and the change of economic model. During the Kirchner administration, there were far fewer connections and much less ideological affinity between the financial sector and cabinet members. This new state of affairs was not surprising given the reduced economic importance of the financial sector as well as popular antipathy toward the banks in the aftermath of the crisis.

Weakened structural and instrumental power allowed the tax agency to obtain full access to time-deposit information in 2006 without difficulty. Once the threat and the anticipated impact of disinvestment declined, structural power no longer hindered reform. Not only were the banks less opposed to giving the tax agency time deposit information, they were also in a much weaker position to resist, given their reduced instrumental power and lingering public outrage against the financial sector.<sup>31</sup> As a tax agency official noted, “En la comunidad con el sistema bancario que le iba a ver con muy malos ojos, que encima de lo que ocurrió no diera la información,” (AFIP A 2006, author's interview). The decline in structural power, however, was the critical factor that made reform possible after 2001; even if the financial sector's instrumental power had remained strong, the banks probably would not have resisted the reform. The tax agency's involvement in other initiatives, including several major anti-evasion reform packages, explains why it did not turn to the issue of time deposit information until 2006.<sup>32</sup>

The role of crisis in facilitating bank information access explicated above differs from other arguments advanced in literature on economic reform. Weyland (2002), for example, argues that countries are more likely to adopt reforms in times of severe economic crisis, because policymakers become more inclined to accept the associated risk. That argument and others that explain reforms implemented *during* crises do not apply to the reform at hand, which took place well after Argentina's 2001 crisis. The tax agency obtained time deposit information not because policymakers were more willing to risk disinvestment, but instead because that risk had significantly declined. My argument that the 2001 crisis improved prospects for reform by helping to reduce structural power is similar to Hacker and Pierson's (2002: 297) observation that if investment has already declined significantly, further disinvestment may have little affect.

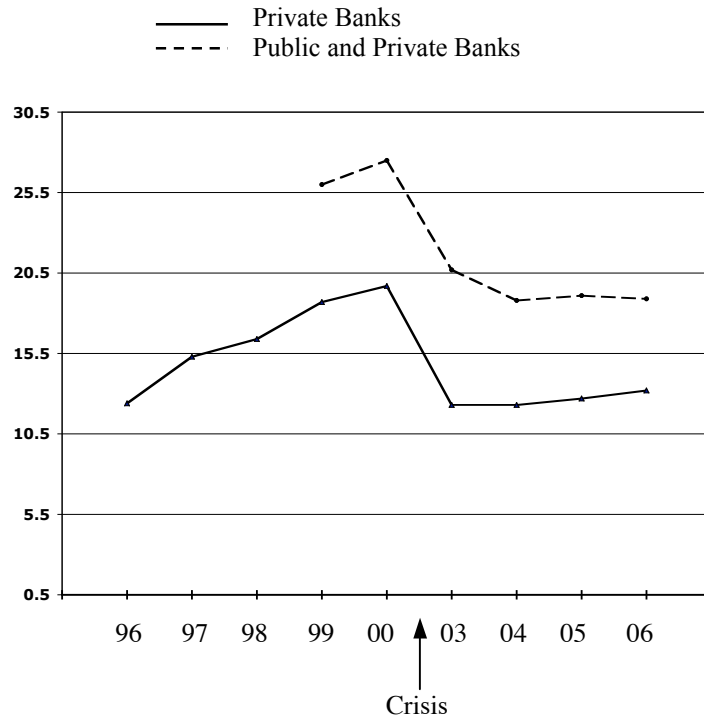
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<sup>30</sup>In retrospect, expanded information access did not appear to have any affect on funds in time deposits; these accounts continued to grow from December 2006 through May 2007.

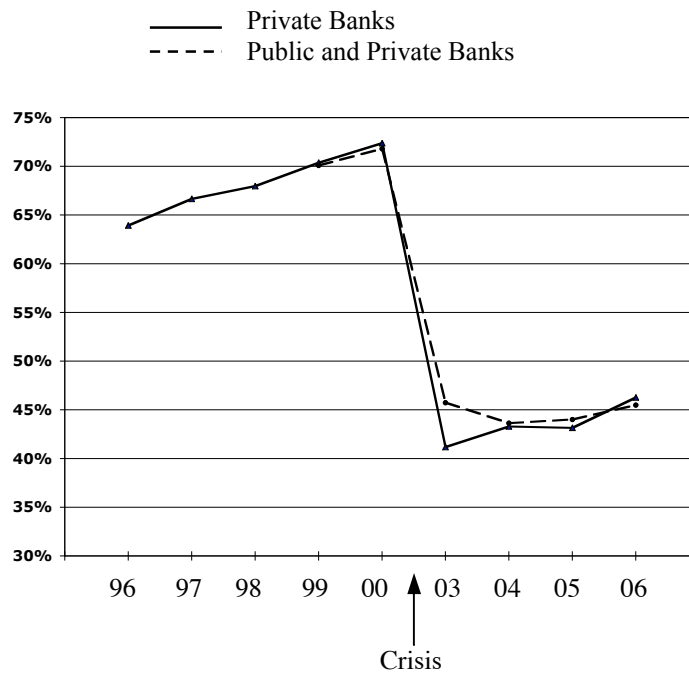
<sup>31</sup>The financial sector was reluctant to make demands on the Nestor Kirchner administration for fear of further degrading its public image. During Cristina Kirchner's presidency, the banks continued to maintain a low profile, so as not to enter into conflict with the government, and to avoid calling attention to the fact that their business had become profitable once again. The banks were concerned that either the public would agitate for, or the government would decide to implement, policies that would impinge on their profitability (Financial Sector B 2008, author's interview).

<sup>32</sup>In the post-2001 context of greatly weakened business power, the tax agency was able to obtain access not only to time-deposits, but also to financial transfers into and out of the country, a measure that had also proved impossible during the 1990s (BCRA 2002, AFIP A 2007, author's interview).

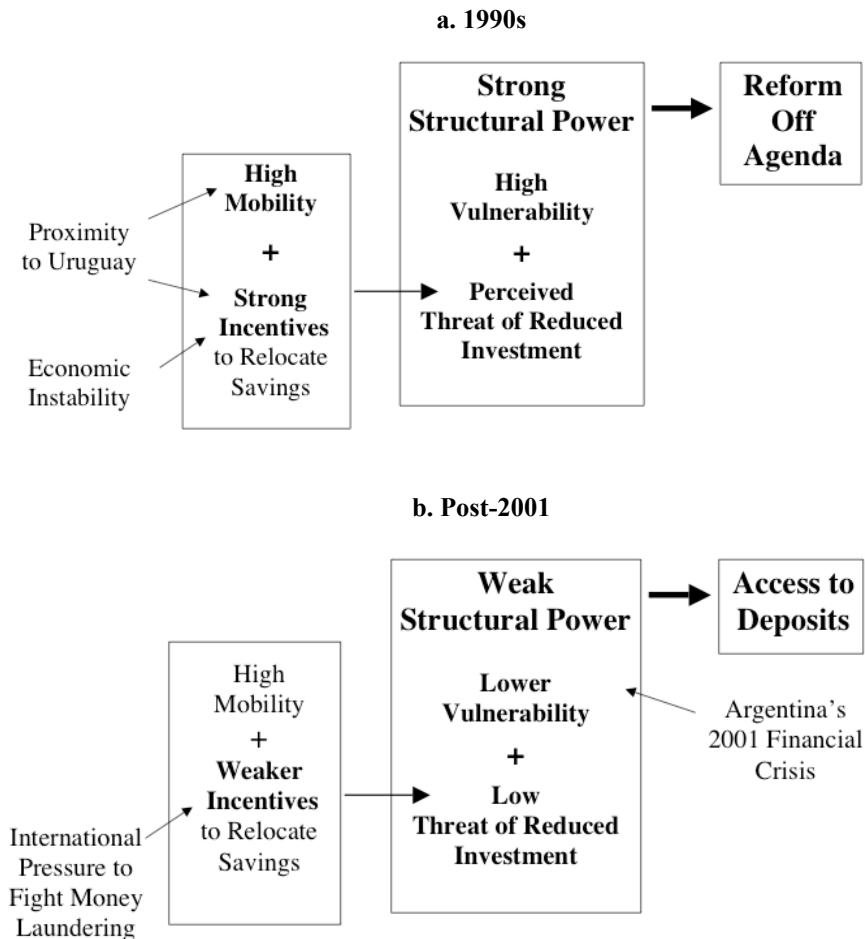
**Figure 6.1.8: Private Sector Bank Deposits in Argentina, %GDP**  
 (Private Sector Deposits in Checking Accounts, Savings Accounts, Time Deposits, and Other Accounts)  
 Data are for December of each year. Source: BRCA, *Informe De Entidades Financieras*



**Figure 6.1.9: Fixed-Time Deposits in Argentina, % Total Deposits, Pre- and Post-Crisis**  
 (Private Sector Deposits in Checking Accounts, Savings Accounts, Time Deposits, and Other Accounts)  
 Data are for December of each year. Source: BCRA, *Informe de Entidades Financieras*



**Figure 6.1.10. Structural Power and Bank Information Access in Argentina**



### **Comparative Perspective: Instrumental Power Hinders Access to Bank Information in Chile**

Like its Argentine counterpart, the Chilean tax agency has sought increased access to bank information since the early 1990s in order to control income tax evasion. Income tax evasion in Chile is essentially as high as in Argentina—40-50%, and under-declaration is a major problem (author's interviews: Jorratt, 2005, SII C 2007). As in Argentina, income tax evasion is most problematic among upper-income individuals with non-wage income—the only taxpayers who have opportunity to evade by under-declaring assets. As shown in Chapter 3, non-wage income accrues disproportionately to taxpayers at the top of the income distribution. In fact, only 5% of adults receive income from non-wage sources in Chile.<sup>33</sup> By a very rough estimate, income tax evasion by the top 1% of adults cost the government 0.7-0.9% of GDP in 2004.

Whereas the Argentine tax agency needed access to time-deposits, the Chilean tax agency sought but could not obtain access to checking accounts. Checking account information was the most relevant bank information for reducing evasion in Chile, given the country's structure of deposits and dominant forms of evasion, just as access to time-deposits was most critical for controlling evasion in Argentina (author's interviews: Jorratt 2007, AFIP A 2006).

<sup>33</sup> Author's calculations based on database from Michael Jorratt.

Although Chile made some progress in the 1990s at expanding access to bank information, access to checking accounts remained off the agenda through 2008.<sup>34</sup> Whereas by 2006, access to bank information in Argentina was more extensive than in many European countries (author's interviews: AFIP A, D, E), Chile appeared on a list of eight financial centers that still had not implemented OECD standards on information access (OECD 2009c).<sup>35</sup> Chilean legislators and finance ministry officials referred to this list as the OECD "grey list."<sup>36</sup> The Chilean tax agency could obtain checking account information only with judicial authorization and only in cases where fraud had already been detected. The tax agency therefore could not use deposit information to screen tax returns for undeclared assets. In Argentina, in contrast, banks routinely provide all information on all of their clients' deposits and transactions that the tax agency deems relevant for controlling evasion. In 2009, the Chilean government finally passed a reform that softened banking secrecy rules with regard to checking accounts; however, the scope of the reform was quite limited.

International pressures alone cannot account for Chile's lack of progress on bank information access compared to Argentina in the post-9/11 era. Both countries experienced similar pressures from OECD countries through 2008, especially the US, to soften banking secrecy. In fact, failure to initiate reform in this policy area prevented Chile from signing a double taxation treaty with the US; Chilean governments had actively sought out such agreements since 1990 (Etcheberry 2005, author's interview). Australia also demanded bank information access as a prerequisite for signing a tax treaty with Chile to no avail (SII C 2007, author's interview).

One might imagine that a more liberal legal tradition or a stronger rule of law account for Chile's lack of progress compared to Argentina's success. However, banking secrecy laws in both countries greatly restricted tax agency access to all types of bank information in the 1970s and 1980s.<sup>37</sup> Further, expanding access to bank information in Argentina did not entail violation of the rule of law or arbitrary action on the part of the state. Instead, governments legislated reforms with congressional approval in the 1980s and early 1990s that served as the basis for full information access. Once again, business power is critical for understanding the timing and extent of reform.

In contrast to Argentina, structural power did not create obstacles to reform in Chile; tax agency access to checking deposits elicits no credible threat of disinvestment (Etcheberry 2005, author's interview). First, checking accounts are much less mobile than savings accounts. Because checking accounts are regularly accessed, it is much more difficult to move them offshore. Second, Chile's banking system, currency, and economy have been remarkably stable since the late 1980s; the conditions that created incentives for depositors in Argentina to remove funds from the banks in response to changes in tax agency oversight are absent in Chile. Moreover, previous experience suggests that Chilean depositors would not alter their behavior in response to greater tax agency oversight. When the tax agency obtained access to bank records on interest earnings in 1995, the only observed response was an increase in interest earnings declared on tax returns (Etcheberry 2005, author's interview).

Instead, business's strong instrumental power and cross-sectoral opposition to reform explain the tax agency's limited access to bank information. In contrast to Argentina, where business leaders outside the financial sector expressed little concern over the issue, business opposed softening banking secrecy much more broadly in Chile (CPC 2000: 6, author's interviews: Ariztía 2005, CChC 2005, Etcheberry

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<sup>34</sup>Chile's tax agency won access in 1995 to bank information on interest earnings, which are included in the income tax base, and this right to information was extended to interest paid on government and corporate bonds in 2001 (Etcheberry 2005, author's interview). However, access to checking accounts would be a much more powerful tool for detecting undeclared income (Jorratt 2007, personal communication).

<sup>35</sup>A longer list designated tax havens that had not yet implemented these standards. The OECD (2009b) was particularly concerned with information exchange, but exchanging information required that tax agencies be able to obtain information.

<sup>36</sup>Informe de la Comisión de Hacienda del Senado, Boletín 6.477-05: 10; 12-13; Diario de Sesiones del Senado, Legislatura 357a, Sesión 58ª, Oct. 14, 2009: 103.

<sup>37</sup>The Pinochet dictatorship established strict banking secrecy laws in 1986, whereas in practice the tax agency had greater information access in prior periods (SII A 2005, author's interview).

2005, Aninat 2007).<sup>38</sup> This opposition did not arise from concern over investment, nor did it arise from anticipations that evading corporate taxes would become more difficult. Rather, this opposition apparently stemmed from reluctance to empower the tax agency to better audit individual income taxes. Large firms are closely monitored and rarely evade taxes, so granting the tax agency access to checking accounts would have little impact on their tax burden. However, business associations in Chile tend to represent not just the interests of corporations, but also the interests of capital owners as individuals, a reality that is not surprising given strong business resistance to redistribution. A high-level tax agency informant explained:

Big business owners do not want the tax agency to look over their personal checking accounts—not the *business's* checking account, but the *personal* account. The business associations say they have nothing to hide: our accounts are open for review. But in a more concealed manner, they lobby against reforms to open checking accounts. (SII C 2007, author's interview and translation)

Simply put, in the words of the former Tax Agency Director: “In Chile people don't want the tax agency to have the information. They realize that they will have more trouble evading taxes,” (Etcheberry 2005, author's interview).

As in the case of corporate tax increases (Chapter 3), instrumental power arose from cohesion, partisan linkages, and government-business concertation that created incentives to avoid conflict with business. The tax agency requested access to checking accounts while the 2000 Anti-Evasion Reform was being designed, but the Finance Ministry dismissed the reform as infeasible. Tax agency informants interviewed in 2007 were quite pessimistic regarding prospects for reform in the foreseeable future (SII C 2007, author's interview).

In 2009, however, international pressure of a qualitatively different kind helped place access to checking accounts squarely on the national agenda. International pressure to soften banking secrecy grew more intense in the aftermath of the 2008 global financial crisis as OECD countries sought both to increase banking regulations and to protect their tax bases in the context of recession. This new international context led to a widespread consensus in favor of lifting banking secrecy restrictions around the world; in September 2009, the OECD Secretary General optimistically asserted: “the era of bank secrecy is coming to an end,” (OECD 2009a). More importantly, the prospect of OECD membership created major positive incentives for Chile to expand tax agency access to bank information. During the final stages of Chile's application process, the OECD made loosening banking secrecy an explicit requirement for securing much-coveted membership in the organization. Whereas prior pressure from the US and other international actors to loosen banking secrecy laws had little effect, the national prestige and benefits associated with OECD membership created a previously non-existent political space for reform.

The executive proposed reform in April 2009 amidst significant controversy; among four reforms required for entry into the OECD, loosening banking secrecy with respect to checking accounts was expected to be the most difficult.<sup>39</sup> Nevertheless, an agreement with right party legislators in August 2009 improved prospects for approval,<sup>40</sup> and the reform was finally legislated at the end of October. References to the requirement for OECD membership, as well as the worldwide tide toward greater transparency, were pervasive in the congressional debates. Finance Minister Velasco amply exploited these issues to the government's benefit. In response to lingering resistance from within the right, Velasco declared:

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<sup>38</sup>A former CPC leader, for example, asserted: “... defiendo [el Servicio de Impuestos Internos] porque ha ordenado mucho a toda la actividad económica nacional, super-eficiente, moderno, creo que es un orgullo para Chile. Dónde protesto o me opongo: que esto no signifique que por apoyar a impuestos internos también tengamos que tener acceso a nuestras cuentas corrientes con toda facilidad. No podemos ser acosados por el servicio de impuestos internos ...no nos llenen de inspectores y revisiones,” (Ariztía 2005, author's interview).

<sup>39</sup>*El Mercurio*, July 11, 2009: “El Gobierno busca concretar la membresía ante el grupo a fines de 2009: Chile aprueba 10 exámenes de la OCDE y está pendiente de otros siete para su ingreso.”

<sup>40</sup>*El Mercurio*, Santiago, August 6, 2009: “Cámara aprueba proyecto de información tributaria que levanta secreto bancario,” by Hernán Cisternas.

...debo decir que me sorprende, de personas que usualmente expresan cierta preocupación por el crecimiento económico, por el desarrollo, por las exportaciones, por la inserción de Chile en el mundo, no tomar en cuenta lo absolutamente clave que es para nuestro país, como exportador de servicios en general y de servicios financieros en particular, tener normas aceptadas por la comunidad internacional. Si queremos jugar en las grandes ligas, debemos ceñirnos por aquellas que hoy día se les aplican a todos... La época en que Suiza, Bélgica, Austria, Luxemburgo tenían reglas distintas se acabó, sencillamente se terminó.<sup>41</sup>

As expected given business's strong instrumental power, however, the reform proposal was extremely limited in scope. The tax agency would now be able to request checking account information in cases where fraud (*delito*) had not yet been detected. However, the tax agency would be required to obtain express consent from the account owner authorizing the bank to release information, otherwise the case would be sent to the courts, and the tax agency would not be able to obtain the information without judicial authorization.<sup>42</sup> These substantial restrictions prompted former Tax Agency Director Etcheberry to openly criticize the proposal in the press: "Me parece muy tímido. No veo razón por la cual el SII no tenga amplio acceso a la información bancaria. El proyecto es muy restringido."<sup>43</sup> While the reform represents a step forward and complies with the minimal OECD requirements, it gives the tax agency very little additional capability to cross-check tax declarations against bank records in order to detect evasion. The contrast with Argentina, where tax agency access to bank information is automatic and essentially unrestricted, remains stark.

**Figure 6.1.11: Business Power and Bank Information Access Outcomes, Chile and Argentina, 1991-2008**

	Chile			Argentina	
	1990s	2001-2008	2009	1990s	Post-2001
<b>Instrumental Power</b>	<b>Strong</b>	<b>Strong</b>	<b>Strong</b>	<b>Strong</b>	<b>Weak</b>
Level	Cross-Sectoral			Sectoral (Finance)	
<b>Structural Power</b>	<b>Weak</b>	<b>Weak</b>	<b>Weak</b>	<b>Strong</b>	<b>Weak</b>
<b>International Factors</b>	NA	<b>Pressure to Fight Money Laundering and Sign Tax Treaties</b>	<b>Condition for Joining OECD</b>	NA	<b>Pressure to Fight Money Laundering</b>
<b>Outcome</b>	<b>No Reform</b>	<b>No Reform</b>	<b>Marginal Reform</b>	<b>No Reform</b>	<b>Significant Reform</b>

### **Taxing Interest Post-2001: Structural Power and Reduced Revenue Capacity Preclude Reform**

Despite Argentina's advances on bank information access, no reforms were initiated to tax interest earnings after 2001. The reduced revenue capacity of this reform in the post-crisis era, along with

<sup>41</sup>Diario de Sesiones del Senado, Legislatura 357a, Sesión 58, Extraordinaria, Oct. 14, 2009: 107.

<sup>42</sup>Mensaje 204-357; *El Mercurio*, Santiago, Aug. 6, 2009: "Cámara aprueba proyecto de información tributaria que levanta secreto bancario," by Hernán Cisternas.

<sup>43</sup>*El Mercurio*, July 14, 2009: "Javier Etcheberry habla del secreto bancario y de temas tributarios por primera vez desde que en 2002 dejara el SII," by Eduardo Olivares C.



structural power, which was still perceived to be strong with respect to this policy area, explain this outcome.

Reduced funds in interest-earning accounts and lower interest rates eroded the amount of revenue that could be raised by taxing interest earnings post-crisis. The value of private funds deposited in interest-earning bank accounts as a percent of GDP decreased from an average of 23.4% GDP in the years 1999-2000 to only 13.0% GDP in the years 2003-2005.<sup>44</sup> Interest rates declined as well; they were approximately half as high as they had been in the 1990s.<sup>45</sup> An extremely rough estimate using 2005 data yields a potential revenue gain of only 0.08% GDP for taxing interest earned on bank accounts (information on interest from corporate bonds is not available), compared to a more substantial figure of about 0.3% GDP in 1999. Further, tax evasion via *autoprestamos*, a problem linked to the interest earnings exemption, was much less prevalent after 2001 than in the 1990s. Stricter regulations on operations conducted through tax havens as well as more effective tax agency oversight procedures and more advanced information systems helped to control this tax evasion mechanism (AFIP A 2006, author's interview).

The reduced revenue capacity of taxing interest earnings helped discourage governments from initiating reform (author's interviews: Di Gresia 2006, Lavagna 2006). Former Economy Minister Lavagna (2002-2005) did consider the possibility of taxing interest earnings, but he decided against doing so, in large part because of the low revenue potential. In addition, real interest rates were actually negative during much of Nestor Kirchner's term, which made this reform less reasonable from the perspective of taxing actual income and profits (Lavagna 2006, author's interview).

Competing priorities also helped keep this reform off the agenda. The Kirchner administration was particularly concerned with keeping interest rates low after 2005; taxing interest earnings would most likely have caused interest rates to rise (author's interviews: MECO A 2006, Wilson 2008). Although several officials and technical advisors within the Economy Ministry expressed interest in reconsidering the tax exemption toward the end of Kirchner's term (author's interviews: MECO A, B 2006), their suggestions were not heeded.<sup>46</sup>

Revenue-capacity and competing priorities aside, structural power with respect to taxation of interest earnings remained strong in the post-2001 era. A credible exit threat persisted. First, policymakers as well as informants from the financial sector and beyond continued to perceive that eliminating the tax exemption would create strong incentives for investors to remove their savings from the banks. As an informant from the Subsecretariat of Public Revenue (DNI AF A 2006, author's interview and translation) explained:

Today, the population is still very sensitive because the debacle [2001 crisis] was not so long ago, and people totally lost confidence in the banks. Deposits are only just now starting to return to the banks. If you suddenly tax [interest] income, people will take their money out in fright, and once more the banks will be left without money. It could produce a run on the banks.

Former Finance Minister Miceli (2008, author's interview) argued against reform following a similar logic:

Hay que estar muy seguro de que si usted aplica un impuesto a la renta financiera, no van a huir los depósitos de los bancos. ...Debería pasar por lo menos 10 años más antes de poner este impuesto. Argentina tiene una historia de crisis financiera una

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<sup>44</sup>Includes deposits in private and public banks. Author's calculations based on BCRA, *Informe de Entidades Financieras*.

<sup>45</sup>BCRA, *Tasas de Interés por Depósitos*.

<sup>46</sup>In February 2006 newspapers reported that Economy Minister Miceli had convoked a panel of experts to prepare suggestions for tax reform; taxing interest was among the anticipated recommendations mentioned to banking sector representatives (Wilson 2008, author's interview; *Clarín*, Feb. 19, 2006: "El Gobierno ya trabaja en un proyecto de reforma impositiva," by Alcadio Oña). Kirchner declared the following day that the tax reform commission did not exist and that no such reforms would be initiated (*Clarín*, Feb. 19, 2006: "El Gobierno ya trabaja en un proyecto de reforma impositiva;" *Clarín*, Feb. 20, 2006: "Kirchner: no se prepara una reforma impositiva;" *La Nación*, Feb. 20, 2006: "Desmintió Kirchner que se estudie una reforma impositiva.").

cada 10 años. En el año 80 en plena dictadura militar, quebraron 10 bancos en un crash financiero ... la gente retiró masivamente todos sus depósitos. En el año 89-90, se implementó lo que acá se llamó el Plan Bonex. Toda la gente que tenía depósitos en los bancos, se levantó el día siguiente, el gobierno lo dijo no puede tocar. Le damos un bono a 10 años. Terrible. Nadie creyó mas en nada. Bueno vino la convertibilidad de Cavallo, se reinstituyeron ciertas reglas de confianza, la gente volvió al sistema financiero, vino la crisis del 2001. Todo el mundo retiró los depósitos. El corralito, el corralón... Si por allí llegamos al año 2010 o 2012 sin que nadie le roba los depósitos a la gente, después se puede hablar de renta financiera.

The 2001 crisis therefore enhanced perceptions of investor sensitivity to taxation of interest earnings by renewing memories of economic instability. In contrast to the case of bank information access, no other factors acted to reduce incentives for relocating funds (Figure 6.1.12). Whereas access to time-deposits was less likely to be interpreted as a sign that financial assets were insecure, given the context of concern over money-laundering, taxing interest earnings could still be perceived as a red flag. Moreover, taxing interest earnings reduces the profitability of bank deposits, whereas tax agency access to bank information has no direct impact on profits. Accordingly, taxing interest earnings should inherently create stronger incentives to relocate funds than granting the tax agency information on time deposits.

Second, the impact on the financial sector of disinvestment provoked by taxing interest earnings remained potentially consequential, although the effect on the economy more broadly would still have been smaller than during the 1990s, given the financial sector's reduced share of GDP. Interest-earning accounts, which included both time deposits and savings accounts, still contained the majority of funds in the banks after the crisis (Figure 6.1.13). Whereas time deposits, the only accounts affected by the reform to expand bank information access, contained only 44% of funds at the end of 2005, time deposits and saving accounts, which would both be affected by a reform to tax interest earnings, contained 70% of funds.<sup>47</sup> It is useful to compare the impact of disinvestment across these two policy areas assuming that reforms would provoke similar percent reductions in deposits. Supposing that taxing interest earnings were to provoke a reduction of 25% of the value in time deposits and 22% in savings accounts— half of the respective reductions that occurred over the course of 2001—total funds in the banks would decrease by 17%. Had tax agency access to time deposits also provoked a 25% reduction in time deposits, total funds in the banks would have decreased by only 11%. The impact associated with taxing interest earnings is 52% greater.<sup>48</sup> (In reality, time deposits continued to grow from December 2006 through May of 2007, despite the reform.) Changes in the structure of deposits brought about by the 2001 crisis therefore did not reduce the financial sector's vulnerability to disinvestment in response to taxing interest earnings as much as they reduced vulnerability to disinvestment associated with expanded bank information access (Figure 6.1.12).

In conjunction with the exit threat, a “non-investment” threat helped remove reform from the agenda. Policymakers viewed taxing interest earnings as a potential disincentive for renewed investment in the now much smaller financial sector. As Lavagna (2006, author's interview) explained, “había que favorizar la bancarización.”<sup>49</sup>

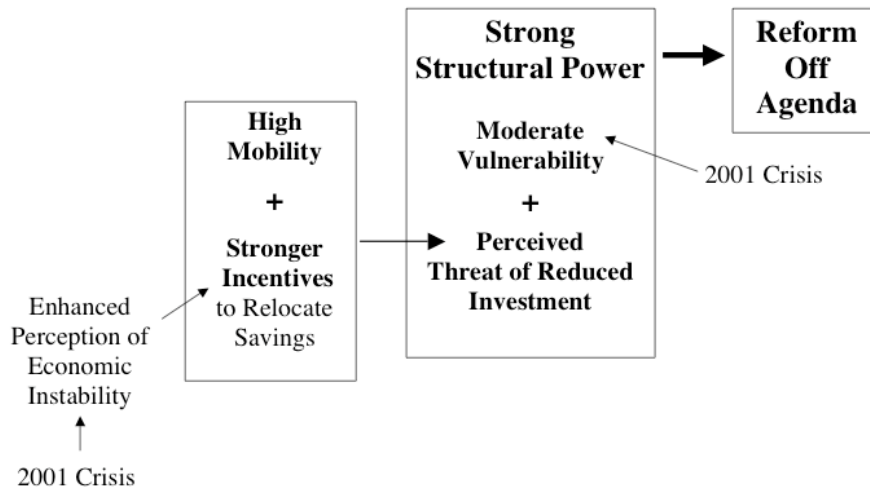
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<sup>47</sup>Private sector deposits in private and public banks. Author's calculations based on BCRA, *Informe De Entidades Financieras*.

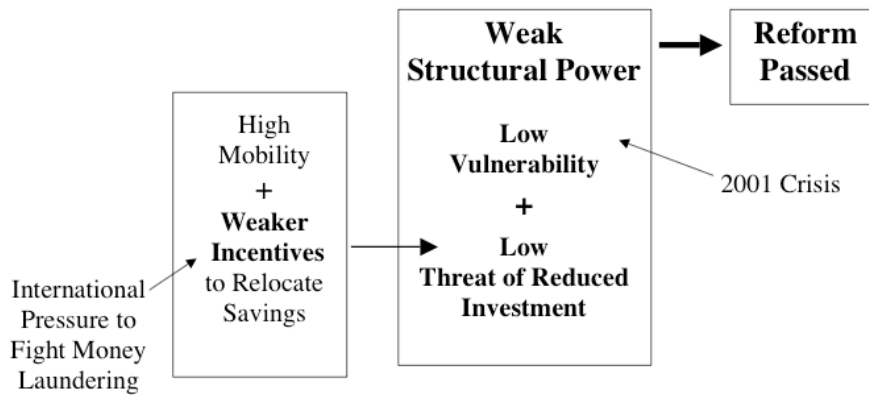
<sup>48</sup>Author's calculations, BCRA *Informe De Entidades Financieras; Información Diaria Sobre Depósitos y Obligaciones, 2001*.

<sup>49</sup>A non-investment threat also removed from the agenda a related reform: taxing capital gains on stocks and real estate, which are also tax-exempt in Argentina. Capital gains were a much more lucrative potential revenue source than interest income after 2001. However, Lavagna (2006, author's interview) decided against taxing capital gains for the sake of promoting post-crisis recovery: “lo único que realmente daba una recaudación distinta era renta de capital, pero bueno allí había que dejar que se recuperara el mercado inmobiliario que se recupera el mercado bursátil, no era el momento para hacerlo.”

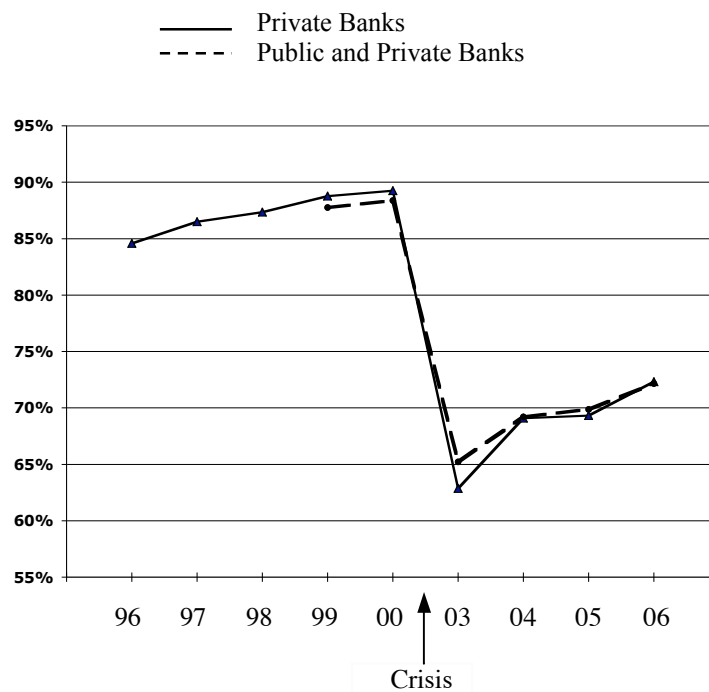
**Figure 6.1.12**  
**a. Taxing Interest Earnings Post-2001**



**b. Expanding Access to Bank Information, Post-2001**



**Figure 6.1.13: Time Deposits and Savings Accounts, % Total Deposits, Pre-and Post-2001**  
 (Private sector deposits in fixed-time accounts, savings accounts, checking accounts, and other accounts)  
 Source: BRCA: *Informe De Entidades Financieras*



## II. Taxing Financial Transactions

In March of 2001, Domingo Cavallo legislated a tax on financial transactions as an emergency measure to control Argentina's growing deficit. De la Rúa had appointed Cavallo, the author of Convertibility, to guide the country out of impending political and economic crisis. The tax affected debits and credits to and from checking accounts at a rate of 0.25%, which was later increased to 0.6%. Ironically, Cavallo had eliminated a prior version of the transactions tax, which he had viewed as distortionary, during his previous tenure as Economy Minister under Menem. However, this tax proved an attractive source of revenue in 2001 for two reasons: first, it was difficult to evade, since the banks automatically withhold the tax when transactions are conducted, and second, it provided the Treasury with an immediate—and daily—source of revenue. The transactions tax collected fully 1% GDP in 2001 after only nine months in existence (DNI AF 2007).<sup>50</sup> As in many other Latin American countries where similar taxes were implemented in times of fiscal distress, the transactions tax has become a permanent feature of Argentina's tax system.<sup>51</sup>

### Weak Structural Power and Strategic Design Facilitate Reform in 2001

One might expect that a financial transactions tax would have been infeasible under Convertibility—like taxing interest earnings, taxing transactions imposes costs on bank customers that could create incentives to avoid the financial system, which played an essential role in the economy. However, whereas taxing interest earnings and granting the tax agency access to time deposits remained

<sup>50</sup>Transactions taxes have the additional benefit of providing the tax agency with more information, which can help control evasion more generally. See for example *Clarín*, March 26, 2001: "Herramienta clave para combatir la evasión," and *Clarín*, March 27, 2001.

<sup>51</sup>See Lledo, Schneider and Moore (2004: 51-52) on transactions taxes in Latin America.

off the agenda until after the economic crisis, the transactions tax was implemented without difficulty in early 2001.

Weak structural power and astute government reform strategies explain this outcome. In contrast to the other two reforms, policymakers did not perceive an exit threat in response to taxing financial transactions. And although the financial sector's instrumental power remained strong in 2001 prior to the crisis, the banks did not oppose the transactions tax. The absence of an exit threat, as well as benefit-side reform strategies employed by the government, explain the sector's acquiescence to the transactions tax, in contrast to their opposition to reform in the other two policy areas.

Structural power was weak primarily because the proposed new tax affected only transfers to and from checking accounts, which as noted previously are much less mobile than savings accounts. Because funds in checking accounts are regularly accessed, it is much more difficult to place these accounts offshore, especially for businesses. For example, opening a checking account in Uruguay would not be feasible because of increased transaction costs arising from interactions with foreign banks and differences in financial regulations (Wilson 2008, author's interview). Further, whereas individuals could decide to withdraw funds from checking accounts and simply guard cash at home, businesses—particularly large corporations, which must operate in the formal sector—did not have that option. In 2001, 82% of the funds in checking accounts belonged to businesses rather than individuals,<sup>52</sup> making any potential exit threat quite minimal. In addition, as discussed previously, checking accounts were empirically less sensitive to changes in banking conditions than time deposits (Wilson 2008, author's interview).

In the absence of a credible exit threat, the banks did not strongly resist the transactions tax. Compared to taxing interest earnings, the banks viewed the transactions tax as a lesser evil. When asked if the sector was concerned about the transactions tax when Cavallo announced the measure, an ABA informant replied: “En un principio, sí. Pero lo que pasa es que lo que iba a afectar eran las cuentas corrientes. Distinto hubiera sido que afectara los depósitos a plazo fijo, que son los más volátiles,” (Wilson 2008, author's interview). Similarly, an ADEBA informant asserted that in contrast to the transactions tax, “gravar la renta financiera ataca al corazón del negocio bancario... atenta contra el sistema financiera institucionalizado,” (Ehbrecht 2008, author's interview). In the absence of an exit threat, the transactions tax would have little impact on the financial sector, aside from some administrative costs. Businesses with checking accounts, rather than the banks, would bear the actual burden of the tax.

Further, strategic reform design helped to minimize financial sector opposition. The government compensated the banks by packaging the transactions tax with another measure that helped to counteract possible disincentives for opening or maintaining checking accounts: lowering the legally allowed maximum for cash payments from 10,000 pesos to 1,000 pesos.<sup>53</sup> The law required payments over 1,000 pesos to be made with either checks or bank cards; the De la Rúa administration had established the prior limit of 10,000 pesos in 2000 as part of an anti-evasion reform package.<sup>54</sup>

Emphasizing stabilization, another benefit-side strategy, helped minimize opposition to the transactions tax in a context of serious concerns regarding the imminent future of the economy and Convertibility. Although the crisis did not culminate until December of 2001, references to fiscal emergency and the possibility of defaulting on the burgeoning debt, which had reached 52.8% of GDP by the end of 2000 (Lagos 2002: 18), were frequent after Economy Minister Machinea's resignation on March 5 and the resignation of his successor, Lopez Murphy, on March 20.<sup>55</sup> Meanwhile, Argentina's risk ratings had more than doubled since 1999 and continued to increase (Lagos 2002: 18); their upward

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<sup>52</sup>BCRA, *Informe de Entidades Financieras*, July 2001. Older data are not available online.

<sup>53</sup>*Clarín*, March 23, 2001: “Los banqueros apoyan el nuevo impuesto a las cuentas corrientes,” in fact explicitly refers to these measures as a compensation for the financial sector.

<sup>54</sup>*Ibid.*, *Clarín*, March 22, 2001: “Buscan apurar la reforma del estado;” Ley 25.345 Art. 1.

<sup>55</sup>*Clarín*, March 26, 2008: “Efecto del apoyo a las medidas que pide Cavallo,” *Clarín*, March 27, 2001.

progress was regularly reported in the news and became a matter of popular concern.<sup>56</sup> Given increasing country risk ratings, access to international credit was becoming more restricted. Accordingly, the Economy Minister asserted that the transactions tax would “recrear la solvencia fiscal y permitir la reapertura del mercado de capitales,”<sup>57</sup> helping to remedy these growing signs of economic instability. Moreover, Article 3 of the proposed reform destined the financial transaction tax revenue to “un Fondo de Emergencia Pública que administrará el Poder Ejecutivo con destino a la preservación del crédito público y a la recuperación de la competitividad económica.”<sup>58</sup> Even orthodox economists who opposed distortionary taxes on principle agreed with the government that the transactions tax was necessary to bolster state coffers, reduce the deficit, and thereby protect Argentina’s international reputation as a good place to do business.<sup>59</sup> In effect, by raising revenue quickly, the transactions tax could potentially *reduce* an exit threat from international investors that threatened the economy as a whole and the Convertibility regime, which the financial sector and policymakers defended until the bitter end (Woodruff 2005, Cohon 2006). The transactions tax in fact had a positive short-term influence on investor expectations; after the Senate approved the reform on March 24, the stock market experienced a small but notable rebound.<sup>60</sup>

Compensation and emphasizing stabilization proved quite effective. Bank leaders expressed support for lowering the maximum for cash payments and publicly recognized the importance of increasing tax revenue. Regarding the first issue, a Banco Ciudad representative observed that the tighter restrictions on cash payments “acelerará la bancarización, la necesidad de la gente de tener una cuenta, lo que nos traerá nuevos clientes.”<sup>61</sup> With respect to the second issue, the president of HSBC asserted: “el gravamen será un costo para la gente, y también a nosotros nos encarece las operaciones, pero en el futuro provocará una influencia positiva al mejorar la presión impositiva.”<sup>62</sup> Likewise, when asked about the transactions tax, the president of ABA asserted: “si no cerramos la brecha fiscal, tendríamos que tomar dinero a tasas tan altas que implicaría un daño mayor para la economía.”<sup>63</sup> Some complaints over administrative costs were voiced; the banks were given a very short time frame of only four days to establish the new informational systems necessary to withhold the tax from their clients (ABA 2001). And some bankers did express concerns regarding the affect of the tax on their customers and on the banking system.<sup>64</sup> However, ABA released a formal communiqué urging Congress to approve Cavallo’s economic plan, including the transactions tax.<sup>65</sup>

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<sup>56</sup>*Clarín*, March 24, 2001: “Las claves de la ley de competitividad,” *La Nación*, March 29, 2001: “Evaluación de Moddy’s y Fitch.” As one informant recalled, the country risk factor: “había sido incorporado que lo tenía esa información como si fuera la temperatura o la hora” (Financial Sector B 2008, author’s interview). Another informant remarked: “Todos los argentinos fueron especialistas en lo que significaba el riesgo país,” (Ehbrecht 2008, author’s interview).

<sup>57</sup>Cavallo, quoted in *Clarín*, March 22, 2001: “Cavallo prometió que la reactivación será rápida”

<sup>58</sup>*Clarín*, March 22, 2001: “Cavallo prometió que la reactivación será rápida.”

<sup>59</sup>*Clarín*, March 26, 2001: “A favor y en contra.” For example, an economist from CEMA, which had ties to the financial sector, asserted: “la alternativa es ir a un default (cesación de pagos) de la deuda externa.” Similarly, a financial analyst asserted: “el impuesto a las operaciones de cuenta corriente va a traer un incremento en la recaudación que asegura el cumplimiento de las metas pautadas con el FMI y aleja los fantasmas de default,” (*Clarín*, March 26, 2001). The IMF expressed satisfaction over the transactions tax as well, although it hoped that the measure would be transitory (*Clarín*, March 29, 2001: “El plan Cavallo”).

<sup>60</sup>*Clarín*, March 27, 2001: “Los mercados celebran.” According to the article: “Los mercados celebraron ayer con una suba del 5% en acciones y hasta un 3% en bonos la aprobación parlamentaria del impuesto a las transferencias bancarias, con lo cual se alejó la posibilidad de que la Argentina incurra en una cesación de pagos de su deuda. La desaparición de ese fantasma, que había estado omnipresente desde la crisis dejó al descubierto la renuncia del ex ministro Machinea a Economía, bastó para que los negocios en la Bolsa porteña tomaran un dinamismo pensado hace sólo unos días.”

<sup>61</sup>*Clarín*, March 23, 2001: “Dudas por el monto que recaudaría el nuevo impuesto.” In retrospect, however, a banking sector informant asserted that this measure had little impact in practice (Wilson 2008, author’s interview).

<sup>62</sup>*Clarín*, March 23, 2001: “Dudas por el monto que recaudaría el nuevo impuesto.” Although banking sector informants interviewed in 2008 did not remember the transactions tax being perceived as a measure that would improve risk ratings, they did observe that the banks accepted the tax in large part because of the government’s pressing need for revenue (author’s interviews: Financial Sector B 2008, Ehbrecht 2008, Wilson 2008).

<sup>63</sup>*Clarín*, April 4, 2001.

<sup>64</sup>*Clarín*, March 23, 2001: “Posición de banqueros y empresarios.”

<sup>65</sup>*Clarín*, March 23, 2001: “Respaldo empresarial al plan de Economía.”

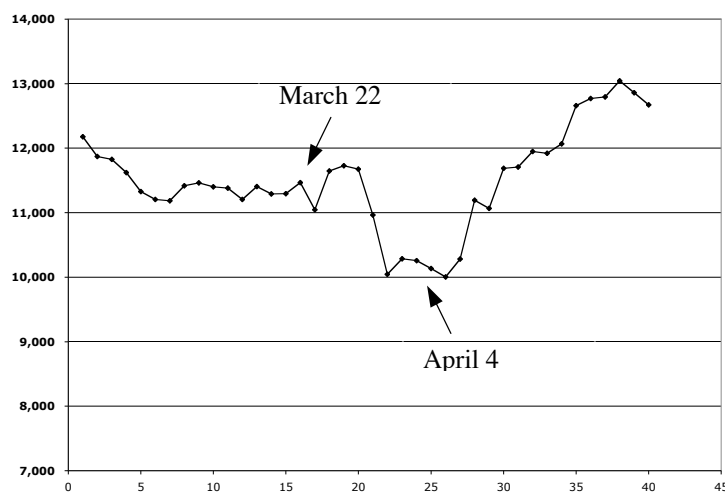
Compensation and emphasizing stabilization also encouraged the private sector more broadly, including those who would bear the actual burden of the tax, to accept the reform. As part of the same package that included the transactions tax—the so-called “Ley de Competitividad”—Economy Minister Cavallo proposed a wide range of economic stimulus measures that included tax benefits for business. These tax benefits and other measures would offset the cost of the new transactions tax.<sup>66</sup> The private sector reacted positively to the announcement. The UIA and the Sociedad Rural, among other groups, openly expressed their support for Cavallo’s reform package.<sup>67</sup>

### The Impact on Checking Accounts in Retrospect

In retrospect, the transaction tax’s impact on checking accounts appears to have been minimal. Checking accounts did begin to decline immediately after Cavallo announced the transactions tax proposal was on March 22; by April 4 when the tax was implemented, the value of funds in these accounts had declined by 11% (Figure 6.1.14). However, the government quickly enacted a number of additional measures that curtailed the problem. Most importantly, the Central Bank decreed that businesses could not open savings accounts, which ended one obvious way to avoid the tax.<sup>68</sup> Thanks to these measures, checking accounts recovered by mid-April (Figure 6.1.14).

Further, the banks viewed the transactions tax as having played a minor if any role at all in the broader process of declining bank deposits that culminated in the December 2001 crisis. An ABA report written in December of 2002 retrospectively pinpointed the beginning of the run on the banks (*corrida bancaria*) to March 2001, but the report identified events including the resignation of two Economy Ministers, the issuing of emergency public bonds, and the removal of the head of the Central Bank in April as the instigators of this process; the transactions tax was not mentioned (Lagos 2002: 17).<sup>69</sup> ABA’s 2001 *Memoria* (Chapter 2: 1) briefly mentioned the transactions tax as a factor that exacerbated negative expectations in March, but the tax was not discussed elsewhere in the 87-page document.

**Figure 6.1.14: Checking Accounts, March 1 – April 30, 2001 (millions of pesos)**  
Source: BCRA: *Información Diaria Sobre Depósitos y Obligaciones*



<sup>66</sup>*Clarín*, March 22, 2001: “Cómo se intentara salir de la recession.”

<sup>67</sup>*Clarín*, March 23, 2001: “Respaldo empresarial al plan de Economía.”

<sup>68</sup>*Clarín*, March 31, 2008: “Trasposos a caja de ahorro;” *Clarín*, March 31, 2001: “Cheques: limitan endosos para que no se eluda el impuesto.” See also ABA 2001, Apéndice: Principales Medidas de Política Bancaria, Cambiaria y Financiera: 2-4.

<sup>69</sup>Banking sector informants did not volunteer the transactions tax as a cause of the crisis either.

### **Retaining the Transactions Tax After 2001: Weak Opposition and Weak Instrumental Power**

Post-crisis governments maintained the transactions tax because of its significant revenue-raising capacity.<sup>70</sup> From 2004-2007, the tax raised an average of 1.8% GDP (DNIAF 2007). Further, the Kirchner administration lauded the transactions tax as progressive, based on the assertion that primarily the middle and upper classes deposit funds in the banks (MECON A 2006, author's interviews).<sup>71</sup> Neither President Nestor Kirchner nor his successor Cristina Kirchner encountered real resistance from the financial sector, or from the private sector more broadly, despite regular complaints that the tax was distortionary and discouraged use of the financial system. In absence of concerted opposition and thanks to business's weak instrumental power, retaining the tax was politically unproblematic.

The banks did not engage in any concerted campaign to convince the government to eliminate the transactions tax after the crisis (author's interviews: Financial Sector B 2008, Ehbrecht 2008)<sup>72</sup> for two reasons. First, consensus appeared to be lacking within the financial sector regarding the impact of eliminating the tax. Some informants asserted that the tax encouraged clients to minimize transactions with checking accounts and discouraged more widespread use of the banking system (author's interviews: Wilson 2008, Ehbrecht 2008). But not all those who held this view felt that eliminating the tax would have a positive impact, at least in the short-term. According to an ABA informant: "a poner el impuesto, se deja de usar muy rápida las cuentas corrientes, porque se trata de evitar el impuesto. Y al sacarlo, no se vuelve a usar tan rápida como se dejó de usar," (Wilson 2008, author's interview). Other informants, meanwhile, maintained that the tax was simply no longer a concern for the banks. Another informant associated with ABA asserted that the banks and their clients had adjusted to the tax, which he compared to "un niño que ya aprendió a correr, y ya anda solo" (Financial Sector B 2008, author's interview). In his view, the tax did not create any significant disincentives for using the banking system. Businesses still lacked feasible alternatives to operating with checking accounts, and modern advances such as the internet made using the banking system more convenient than in the 1990s.<sup>73</sup> This lack of consensus on the magnitude of the problems created by the tax and consequences of eliminating it may have acted to preclude more significant pressure from the sector.

Second, the banks viewed the transactions tax as a problem that should be dealt with by the rest of the private sector, namely, those who paid the direct cost of the tax. As argued in Chapter 5, political action follows a sectoral logic in Argentina, given business's lack of cohesion at the cross-sectoral level. Instead of defending common business interests, each sector focuses on the issues that most directly affect its own particular interests. In accord with that dynamic, an ADEBA informant explained the banks' low level of activity on the transactions tax as follows:

No es algo que nosotros estamos diciendo constantemente, porque no es una bandera únicamente de los bancos... no es exclusivo al sector. Por allí estamos viendo otras cosas. Por ejemplo, en algunas provincias ...quieren aplicar un impuesto a la captación neta de fondos. Si yo capto fondos en una provincia, y no los presto en esta provincia, sino que lo presto en otro lugar, tengo que pagar un impuesto por lo que no es prestado en la provincia que dio origen a estos fondos. ...Esto sí que es bien del sector para decir no, escucharme: nosotros somos un conjunto... (Ehbrecht 2008, author's interview)

Transactions tax politics in the post-2001 era therefore resembled corporate tax politics more closely than they resembled the politics of taxing interest earnings.

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<sup>70</sup>Economy Minister Lavagna did decrease the rate slightly, however.

<sup>71</sup>This statement is probably partially correct, but it is difficult to evaluate the incidence of the tax because it is in practice paid primarily by businesses, which may be able to pass the burden on to other economic factors.

<sup>72</sup>The banking sector's primary request regarding the transactions tax once economic recovery had resumed was that they be permitted to transfer the revenue to the state once every ten days rather than daily (Financial Sector B 2008, author's interview). The Kirchner administration accepted the modest request.

<sup>73</sup>Individuals, meanwhile, enjoyed exemptions that made the tax less burdensome (salaries or wages deposited each month are not taxed, nor are debits up to the total value of the deposited salary).



Even if the banks had actively opposed the transactions tax, they probably would not have been able to exert influence given their weak instrumental power in the post-crisis era. Likewise, the business sector more broadly lacked cohesion or other sources of instrumental power at the cross-sectoral level. Achieving influence in this policy area would no doubt have required significant sources of instrumental power and concerted collective action, given the importance the Kirchner administrations placed on the transactions tax.

### Overview of the Argument

Figure 6.1.15 summarizes how investors' structural power, the financial sector's instrumental power, and reform outcomes varied across the three policy areas discussed in the 1990s and 2000s. Factors other than instrumental power also contributed to the outcomes. Low revenue-raising capacity helped remove reform from the agenda in the case of taxing interest earnings after 2001. And executive reform strategies contributed to the successful implementation of the transactions tax in 2001. However, business power accounts for most of the variation in outcomes across policy areas and over time.

Strong business power, whether structural, instrumental, or both, tended to remove reform from the executive's agenda. Structural power in combination with instrumental power made reform infeasible in the cases of taxing interest earnings and granting the tax agency access to time deposits in the 1990s. On occasions when one means of influence failed, the other blocked progress in these policy areas. But strong structural power alone prevented reform even when instrumental power was weak. The perception of an exit threat kept taxing interest earnings off the agenda after 2001, notwithstanding the fact that the financial sector's instrumental power declined dramatically after the economic crisis. Conversely, counterfactual analysis suggests that strong instrumental power could have allowed the financial sector to block the transactions tax in 2001, had the banks opposed the measure, even though structural power was weak in this policy area. Only when both structural power and instrumental power were weak—or when the financial sector did not oppose reform—did significant progress occur, as in the cases of bank information access after 2001 and the financial transactions tax.

Regarding structural power, the cases examined here illustrate the importance of both mobility and incentives to relocate investment for creating a credible exit threat. When bank accounts were mobile and policymakers anticipated that reform would create incentives for investors to relocate their deposits, a credible exit threat helped to remove reform from the agenda, as with expanding bank information access in the 1990s and taxing interest earnings during both decades. When accounts were not mobile, structural power was weak, even if reform imposed costs that might otherwise create incentives for depositors to move their funds elsewhere, as in the case of the transactions tax on checking accounts. And when accounts were mobile, but policymakers did not perceive that reform would create incentives to relocate funds, structural power was also weak, as with bank information access post-2001.

**Figure 6.1.15: Structural Power, Instrumental Power, and Financial Sector Tax Policy Outcomes in Argentina, 1990s-2008**

	Taxing Interest Earnings		Bank Information Access		Financial Transactions Tax	
	1990s	Post-2001	1990s	Post-2001	2001	Post-2001
<b>Structural Power</b> (Investors)	<b>Strong</b> High Mobility + Strong Incentives		<b>Strong</b> High Mobility + Strong Incentives	<b>Weak</b> Weak Incentives	<b>Weak</b> Low Mobility	
<b>Instrumental Power</b> (Financial Sector)	<b>Strong</b>	<b>Weak</b>	<b>Strong</b>	<b>Weak</b>	<b>Strong But Not Exercised</b> (Indifferent To Reform)	<b>Weak</b>
<b>Outcome</b>	<b>Reform Off Agenda</b>	<b>Reform Off Agenda</b>	<b>Reform Off Agenda</b>	<b>Reform Implemented</b>	<b>Reform Implemented</b>	<b>Reform Retained</b>

## Part 2. Agricultural Sector Tax Politics

Two important tax policies directly affected the agricultural sector in Argentina in the 1990s and 2000s respectively: the VAT on grains, and taxes on agricultural exports. In 1998, the tax agency sought to lower the VAT rate on grains in order to reduce evasion; however the reform did not succeed until 2002, during the height of the economic crisis. In 2002, export taxes were also imposed on agricultural goods at significant rates for the first time in ten years. Subsequent governments maintained and increased the export taxes, disregarding the producers' objections until 2008. To explain why the producers were able to block the VAT reduction in 1998 but not in 2002, and why they achieved so little influence over export taxes until 2008, I examine the producers' changing sources of power, as well as the role of agricultural export firms, whose interests often diverged from those of the producers. The analysis illustrates the mechanisms through which economic crisis and turnover in the executive branch weakened the producers' power from the late 1990 to the early 2000s, and how a 2008 policy measure perceived as extreme set in motion a process that dramatically increased the producers' instrumental power. Figure 6.2.1 below displays the core elements of the arguments I advance.

Section I analyzes government initiatives to reduce the VAT rate on grains, which would paradoxically raise revenue for the state. I argue that the producers' moderate instrumental power, arising from informal ties to a cabinet member—the Secretary of Agriculture—helped prevent reform in 1998. A fortuitous convergence of interests with the Secretary of Agriculture and the exporters' tacit alliance with the producers, as well as loosely coordinated lobbying by the producers despite their lack of cohesion, also contributed to the defeat of the reform initiative. In 2002, the producers' power declined due to changes associated with the economic crisis. Informal ties became less effective given the Secretary of Agriculture's reduced authority within the cabinet. Meanwhile, the export firms' increased structural power and stronger support for reform counterbalanced opposition from the producers and contributed to reform.

Section II examines export tax politics after 2002. Exporters generally were not relevant actors in this policy area; they did not object to export tax increases because they simply passed the cost on to producers through lower purchasing prices. The producers in contrast adamantly opposed export tax increases, but they were unable to exert influence on this issue from 2002 through early 2008 given their lack of any sources of power, instrumental or structural. In 2008, however, an especially provocative export tax increase catalyzed collective action, despite previously weak cohesion, in the context of multiple accumulated grievances. Increased instrumental power, manifested in sustained capital strikes and unprecedented cohesion, led to the reversal of the 2008 export tax increase and contributed to a significant realignment of political forces in Argentina.

**Figure 6.2.1: Producers' Power, Exporters' Power, and Agricultural Tax Policy Outcomes, 1998-2008**

		Reducing VAT Rate on Grains		Export Tax Rate Increases	
		1998	2002	2002-2008	2008
<b>Producers</b>	<b>Instrumental Power</b>	Moderate	Weak	Weak	Strong
	<b>Structural Power</b>	Weak	Weak	Weak	Weak
<b>Exporters</b>	<b>Structural Power</b>	Weak	Strong (Support Reform)	Generally Not Relevant (Indifferent to Reform)	
<b>Outcome</b>		<b>Reform Failed</b>	<b>Reform Passed</b>	<b>Reforms Passed</b>	<b>Tax Increase Reversed</b>

## I. The Value-Added Tax (VAT) on Grains

### Raising Revenue by Reducing the VAT Rate

In 1998, the tax agency proposed reducing the VAT rate on agricultural products including meat and grains in order to control evasion in the countryside, which had been a major problem throughout the 1990s. When agriculture was included in the VAT base in 1989, the tax agency faced the daunting and unwanted challenge of controlling approximately 200,000 new taxpayers (AFIP A 2006, author's interview). Producers were widely dispersed throughout the interior provinces of Argentina, making them especially difficult to monitor and control.

Special characteristics of the agricultural sector made VAT evasion a much more serious problem in terms of revenue loss than evasion in other sectors of the economy. Argentina is a major exporter of agricultural products, especially grains, soy, oil seeds, and their derivatives. Approximately 80-85% of these products were exported.<sup>1</sup> Because international agreements mandate that domestic taxes cannot be "exported" to consumers outside the country of origin, the state must reimburse exporters for their VAT payments. Grains and meat make their way from numerous, geographically dispersed producers to a small number of major export firms through intermediary collectors. Many intermediaries would offer to purchase goods from producers with cash at above-market rates if the producers agreed not to apply the VAT to the sale.<sup>2</sup> These intermediaries, known as *valijeros* for the briefcases of cash they carried, then made their operations appear legal by forging VAT receipts through sophisticated operations.<sup>3</sup> When they resold their goods to the exporters, all of the VAT documents appeared to be in order. The intermediaries thus made significant profits through tax evasion, while the state ended up owing the exporters reimbursements for VAT payments that had in fact never entered state coffers. The critical point is that the state did not simply forgo potential revenue due to evasion; rather, the state lost actual revenue from general tax collections by reimbursing exporters for VAT payments that the treasury had never received.

Revenue lost due to VAT evasion in the agricultural sector was significant. Reported estimates for evasion in the grains sector varied from a low of USD 300 million to a high of USD 800 million per year.<sup>4</sup> Meat sector evasion was estimated at between USD 700 million and 800 million per year.<sup>5</sup>

To address this problem, in early January 1998, the tax agency proposed reducing the VAT rate on agricultural products from 21% to 10.5%. This reform would reduce incentives for evasion in the commercialization chain and automatically cut reimbursements owed to exporters by a factor of two. Counter-intuitively then, lowering the VAT rate would increase net tax revenue by curtailing the outflow of resources that enriched the intermediaries at the state's expense.<sup>6</sup>

### The Producers' Opposition to Reform

Although one might naively expect that producers would have welcomed a VAT reduction on agricultural goods, they in fact resolutely rejected the initiative. Led by the *Sociedad Rural Argentina* (SRA), producers complained that they would be left with unrecoverable VAT credits, since inputs such as agrochemicals and crop services would remain taxed at 21%. Concern regarding unrecoverable VAT credits had motivated the SRA to demand that agriculture be included in the VAT base in 1989; unless the VAT applied to sales of agricultural products as well as inputs, producers would not be able to transfer

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<sup>1</sup>Fully 95% of soy is exported.

<sup>2</sup>See for example *La Nación*, Feb. 15, 1998, and author's interviews: Exporter B 2006, CONINAGRO 2006.

<sup>3</sup>One common practice involved forming "ghost companies" that were dissolved before the tax agency could identify false receipts and trace their origins.

<sup>4</sup>*La Nación*, Dec. 18, 1997, *La Nación*, June 27, 1998.

<sup>5</sup>*La Nación*, Dec. 18, 1997, *La Nación*, Feb. 15, 1998. No records of official estimates could be located.

<sup>6</sup>In addition to this reform, the tax agency devised a new system for monitoring the VAT in the countryside that entailed creating official registries of grain sellers and a withholding regime to cut down on evasion by intermediaries and producers. Exporters would retain 12% of VAT payments owed to grain sellers, reducing the magnitude of reimbursements owed by the state and encouraging sellers to conduct operations legally in order to recover VAT credits from the tax agency.

the cost of the VAT forward to consumers. Producers associations complained that the differential VAT reduction would unfairly transfer the cost of fighting evasion to producers, including those who abided by the laws. They asserted that the reform would cost producers USD 2000 million per year.<sup>7</sup>

Producers were especially opposed to reducing the VAT rate on grains. Whereas meat production required fewer inputs and profit margins were sufficient that anticipated costs associated with the VAT reduction were manageable, grain cultivation was undergoing a technical revolution that entailed substantial long-term investment and significant input costs, including machinery and agrochemicals (author's interviews: Former SRA 2006, MacLoughlin 2008, Ambrosetti 2008). The SRA argued that reducing the VAT on grain sales but not on inputs would have slowed or reversed this process: "podía generar un atraso de 8 a 10 años... Si ganaba la recaudación, perdía la modernización tecnológica," (SRA B 2006, author's interview). Producers demanded that either the VAT reduction be applied broadly, not differentially, or that they be authorized to use leftover VAT credits against any other tax obligation to the central government. Meanwhile, the producers blamed evasion on the tax agency's own deficiencies, denouncing that: "por la incapacidad del estado de controlar a los ilegales, sancionamos a los legales," (SRA B 2006, author's interview). Framing evasion as tax agency ineptness rather than cheating by producers was a savvy strategy, given the tax agency's poor reputation within society, despite its advances in the early 1990s (Eaton 2002, Bergman 2009).

Producers also objected to the timing of the reform. The executive sought to implement the VAT reduction on meat and grains before the 1998 harvest; producers had already made production decisions taking into account a uniform VAT rate of 21%.<sup>8</sup> Moreover, they complained that the measure would impose an especially heavy burden on agriculture given inclement weather conditions that caused extensive flooding in the north and central pampas, as well as prevailing price and market uncertainties.<sup>9</sup>

### **The Failure of the 1998 Reform Initiative**

The producers obtained two important concessions from the government in 1998. First, the VAT rate reductions were postponed until after the harvest, and second, grains were entirely excluded from the reform. Although their structural power was inconsequential, the producers were able to win these concessions thanks to their instrumental power, which arose from informal ties to the Secretary of Agriculture, as well as a fortuitous convergence of interests with that official and tacit support from the export firms. Loosely coordinated lobbying by the producer associations, despite their lack of cohesion, also contributed to the outcome. The failure of the initiative to lower the VAT rate on grains was not a forgone conclusion, however; the producers' instrumental power with respect to the executive branch was weaker than that of the financial sector in the 1990, and the producers' success ultimately hinged on a decision made by the president that likely involved a significant degree of contingency.

### ***Producers' Weak Structural Power***

Despite producers' complaints that the VAT reduction would harm investment and production,<sup>10</sup> their structural power was weak. Policymakers did not perceive that the reform would have any negative economic consequences. In fact, the administration's economic team was convinced that producers would not be left with unrecoverable VAT credits; as such, the logical link on which arguments that the reform would reduce investment and production depended was faulty. A tax agency technocrat who participated in negotiations with the producers recalled that detailed studies supported the government's position:

Nosotros hemos hechos decenas de estudios que probamos que el valor agregado del sector agropecuario es mayor al 50%, con lo cual el 10,5 le alcanza más que

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<sup>7</sup>*La Nación*, May 7, 1998.

<sup>8</sup>*La Nación*, May 12, 1998.

<sup>9</sup>*La Nación*, Jan. 17, 1998, May 12, 1998, June 6, 1998.

<sup>10</sup>An SRA staff member for example asserted: "La medida tendría un claro sesgo antiproducción y se convertiría en un desincentivo para nuevas inversiones," (Guillermo Mac Loughlin in *La Nación*, Jan. 17, 1998: "La reducción del IVA agropecuario").

sobradamente para computar sus créditos. Salvo que evada al vender. ...Hicimos decenas de modelos teóricos de estructura de costos... [La Secretaría de] Agricultura hizo modelos que estaban muy cercanos a los nuestros. Hemos tomado publicaciones que hacen revistas especializadas en donde coincidían bastante con nuestros modelos. Y sin embargo, el sector se oponía... iban a los casos límites para no tomar las generalidades: “Hay un productor que...” ...“En el norte tienen baja productividad...” (AFIP A 2006: author’s interview).

Similarly, another tax agency official commented that the producers’ arguments against lowering the VAT were inconsistent and “muy graciosas” (AFIP C 2006, author’s interview). The Economy Minister and the Tax Agency Director maintained that reducing the VAT would not hurt the producers throughout the 1998 policy process.<sup>11</sup>

In addition, the context of increasing agricultural production probably further quelled any potential concerns the economic team may have harbored regarding the impact of the VAT reductions. The Secretary of Agriculture announced record grain harvests from January and May, despite the poor weather conditions.<sup>12</sup> At the end of January, for example, the Minister announced that Argentina had come close to achieving the “super cosecha del siglo” at 61 million tons of grains, and the Subsecretary of Foods announced record agroexports in 1997 with additional growth expected for 1998.<sup>13</sup> Foreign officials extolled increased production as well. For example, at the SRA’s annual Rural Exposition in July, an IDB official lauded the achievements of Argentina’s “agricultural revolution.”<sup>14</sup> Given, these considerations, structural power cannot explain why the producers won concessions from the government.

### ***Producers’ Moderate Instrumental Power***

The producers’ instrumental power formed the basis for their influence over VAT policy in 1998. Instrumental power arose from the producers’ informal ties to the Secretary of Agriculture. However, influence afforded by informal ties tends to be highly contingent, and the producers lacked other sources of instrumental power. As such, their strength is best characterized as moderate.

Secretary of Agriculture Felipe Solá developed close relationships with the agricultural producers over the course of his long tenure in President Menem’s cabinet. Menem appointed Solá, an agricultural engineer by training, in 1989. Solá held his position through 1998, with the exception of a brief interlude from 1991 to 1992 during which he served as a deputy in Congress. As Secretary of Agriculture, Solá developed productive working relations with the producer associations, especially the SRA and the *Confederaciones Rurales Argentina* (CRA), which represented large producers who favored Menem’s liberal policies (author’s interviews: Ambrosetti 2008, MacLoughlin 2008). In addition, Solá developed personal connections with the producers, which included a strong friendship with Mario Llambias, president from 1994-2005 of the *Confederación de Asociaciones Rurales de Buenos Aires y La Pampa* (CARBAP), an important member federation of CRA.<sup>15</sup> These informal ties may have made Solá more responsive to the producers’ interests. Although Solá initially supported the Economy Ministry and tax agency’s position in favor of the VAT reductions, the producer associations eventually engaged him as a key advocate within the government (Former SRA 2006, author’s interview).

However, the producers’ instrumental power with respect to the executive branch was not as strong as the financial sector’s instrumental power in the 1990s. While the financial sector enjoyed recruitment into government and informal ties not only to the relevant sectoral ministry but also to Economy Ministry

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<sup>11</sup>The former head of the tax agency recalled that he had to convince Menem and Minister of Economy Fernández that reducing the VAT rate would in fact increase, rather than reduce revenue, given the paradoxical nature of the reform (Silvani 2007, author’s interview). Thereafter, however, The Minister of Economy resolutely supported the tax agency’s position.

<sup>12</sup>*La Nación*, Jan. 31, 1998, May 20, 1998.

<sup>13</sup>Ibid.

<sup>14</sup>*La Nación*, Aug. 14, 1998.

<sup>15</sup>*Clarín*, May 22, 1998.

officials, the producers lacked ties to executive branch decision-makers with direct control over tax policy.<sup>16</sup>

Further, the agricultural producers lacked other sources of instrumental power that might have strengthened their position. Like most other business sectors, the producers did not enjoy strong relationships with legislators (McGuire 1995: 201-2, Heredia 2003: 107).<sup>17</sup> On the one hand, the producers lacked partisan linkages; no electorally significant party responded to producers as a core constituency. On the other hand, informal ties to legislators from the main political parties usually did not constitute an effective source of instrumental power because of strong party discipline and incentives created by Argentina's electoral institutions (Eaton 2002, Chapter 5).

In terms of resources, one of the producers' associations, the SRA, had significant technical expertise, including a permanent team of economic advisors,<sup>18</sup> but, as in Chile, Tax Agency and Economy Ministry officials were themselves highly trained technocrats with the ability to independently evaluate the private sector's technical arguments. As discussed above, these officials viewed the producers' arguments against the VAT reform self-serving and ill-founded.<sup>19</sup>

Moreover, the producers patently lacked cohesion, given organizational fragmentation, geographical dispersion, and heterogeneity of interests. Four different associations represented different types of producers. The *Sociedad Rural Argentina* (SRA), the oldest and most prestigious of the four organizations, represented the largest producers. *Confederaciones Rurales Argentina* (CRA) represented large producers as well, although its average member tended to own fewer hectares compared to the SRA equivalent. The *Confederación Intercooperativa Agropecuario* (CONINAGRO) represented agricultural cooperatives, which tended to agglomerate smaller producers. Finally, the *Federación Agraria Argentina* (FAA) represented the smallest producers. Given the differences in constituencies, conflicts of interest among the associations, in addition to coordination problems, were common. For example, the FAA favored state regulation of commercialization and policies to prevent land from concentrating in the hands of large commercial interests, financial capital, or foreign owners, while the SRA strictly advocated free market policies (author's interviews: CONINAGRO 2006, Landgraf 2006).<sup>20</sup> Meanwhile, CONINAGRO had stronger incentives to support anti-evasion measures than the other associations because the cooperatives it represented operated in the formal sector and were hurt by tax evasion elsewhere in the agricultural sector (author's interviews: CONINAGRO 2006, Lamberto 2006). In addition, the producers associations preferred different tactics for advancing their interests. The CRA and FAA frequently attempted to organize strikes, whereas the SRA and CONINAGRO opposed the use of strikes as a pressure tactic and preferred to pursue dialog with the government whenever possible. SRA and CONINAGRO staff members expressed the view that strikes imposed high costs on producers, were difficult to coordinate and sustain, and tended to accomplish little (author's interviews: CONINAGRO 2006, Landgraf 2006, SRA A 2006 and 2008).<sup>21</sup>

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<sup>16</sup>This state of affairs contrasted starkly with the *Sociedad Rural Argentina's* (SRA) recruitment into government during prior periods. Schneider (2004: 186) notes that the SRA held 30 appointments in the military governments that ruled Argentina from 1966-73; a subsequent Finance Minister, Martínez de Hoz, was also a member of the SRA.

<sup>17</sup>See McGuire (1995: 202) for a discussion of "landowners' isolation from party politics." Heredia (2003: 107) found in interviews that SRA leaders: "No establecieron ni distinciones ni preferencias en relación con los partidos mayoritarios...."

<sup>18</sup>Revenue from the Palermo convention center, which Menem sold to the SRA at a sum far below market price in 1991 (Heredia 2003: 90), allowed the SRA to maintain an Economic Studies Institute (Zavala 2008, author's interview).

<sup>19</sup>Although SRA informants (MacLoughlin 2008, author's interview) asserted that they won concessions on the 1998 VAT reduction because their technical arguments convinced the government that the reform was inappropriate, interviews with government officials involved in the negotiations with the producers indicate otherwise.

<sup>20</sup>See also *Perfil*, May 25, 2008, *La Nación*, Oct. 4, 2007. Differences of interests arose in other areas as well, including credit policy and the issue of privatizing the Banco Nacional (Sidicaro 2002: 194-6). See also Viguera 2000: 35.

<sup>21</sup>An SRA informant asserted: "institucionalmente, no estamos de acuerdo con los paros," (SRA A 2006, author's interview). Likewise, a CONINAGRO (2006, author's interview) informant asserted with regard to strikes, "lo único que se perjudica es la gente, los productores." See also Sidicaro (2002: 189). The different structures and membership bases of the four producers' organizations contributed to this divergence of opinion on strategies. The CRA represented provincial producers' confederations whose members relied on agriculture for their livelihoods (CRA 2006, author's interview). The CRA's bottom-up organizational structure made it very responsive to demands from producers on the ground (author's interviews: CRA 2006, SRA A 2006), who

The producers' moderate instrumental power based exclusively on informal ties to a cabinet member was not necessarily sufficient for securing the defeat of the 1998 reform initiative. Two additional factors contributed significantly to the outcome: a fortuitous convergence of interests with the Secretary of Agriculture, and the export firms' tacit alliance with the producers, despite the former's support for reducing the VAT rate on grains.

### ***Fortuitous Convergence of Interests with the Secretary of Agriculture***

In their bid to defeat the VAT reform, the producers benefited from a fortuitous convergence of interests with the Secretary of Agriculture, thanks to Solá's personal political ambitions. Solá's intention to run for governor of Buenos Aires was a matter of public record by mid January of 1998.<sup>22</sup> To further his electoral prospects, he sought to maintain an image of competence and authority within the cabinet. According to an agricultural leader interviewed by *La Nación*, the newspaper that most closely covers issues of interest to the agricultural sector, Solá felt that the Economy Ministry and the Tax Agency's failure to consult with him as they pushed the VAT reduction forward in the context of growing protest from the producers undermined his authority.<sup>23</sup> This apparent weakness, as well as a failure to deliver benefits for agricultural producers, could have become a serious political liability in Solá's electoral bid.<sup>24</sup> Accordingly, Solá became a strong advocate for the producers within the executive branch.

### ***Export Firms' Tacit Alliance with the Producers***

The producers also benefited from the export firms' decision to assume a low profile in 1998 on the VAT issue, despite the fact that the reform was in their interest. Had the exporters chosen to lobby actively in favor of the VAT reduction rather than tacitly allying with the producers, the latter may have been in a weaker position to resist the reform.

The exporters stood to gain significantly from reducing the VAT rate on grains because the state regularly fell into arrears on its VAT reimbursements, which imposed significant financing costs on the export firms. The VAT reduction would have reduced these financing costs by about USD 600 million per year.<sup>25</sup> The exporters themselves reportedly proposed this measure to the government in the late 1990s (author's interviews: Exporters A and B 2006).

However, once the intensity of the producers' opposition became manifest, the exporters opted not to take a strong position in favor of the measure; they preferred instead to maintain good relations with producers. As an export firm informant explained, the exporters "no apoyó la medida en forma expresa, por una cuestión política, porque nosotros formamos parte de esta cadena y de este grupo" (Exporter A 2006, author's interview). Similarly, another informant remarked: "Nosotros en nuestra actividad no podemos decir a los dirigentes de los productores 'ustedes están representando a evasores,' porque eso no se lo podés decir. Pero esa es la realidad objetiva..." (Exporter B 2006, author's interview). The

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tended to support confrontational measures when negotiations failed. Moreover, the CRA's diffuse organizational structure hindered the leadership's ability to make and enforce decisions, which may have made it more difficult to engage in productive dialog with the government. The SRA, in contrast, was a centralized, top-down organization, which facilitated negotiation with the government (SRA A 2006, author's interview, Heredia 2003: 104). Its membership consisted of large individual producers who often engaged in non-agricultural economic activities as well (CRA 2006, author's interview); Schneider (2004: 188) notes that SRA leaders from 1955-83 had "maintained diversified business interests in finance, commerce and industry." The economic fortunes of SRA members were therefore not as dependent on agricultural policy as members of the other producer associations; favorable reforms policies in other realms could potentially compensate for sub-optimal reforms in agricultural policy. As such, SRA members and leaders tended to opt for negotiation and preferred to maintain cordial relations with the government.

<sup>22</sup>*La Nación*, Jan. 15, 1998.

<sup>23</sup>*La Nación*, May 21, 1998.

<sup>24</sup>"...en la carera política de Solá, el IVA que quiere instrumentar Silvani [director of the tax agency] se iba a transformar en una mancha difícil de sobrellevar, y encima sin que el haya participado en la decisión," (*La Nación*, May. 21, 1998).

<sup>25</sup>*La Nación*, May 9, 1998. Exporter B 2006 (author's interview) recalled a figure of 500 million dollars. See also *La Nación*, Nov. 21, 1998.

exporters did make a few public statements in support of reducing the VAT, but they had little influence on the policy process, given that they were published after the producers had obtained the key concessions.<sup>26</sup>

By failing to actively support the VAT reduction, the exporters in effect formed a tacit alliance with the producers. A tax agency official who participated in discussions with producers and exporters in 1998 perceived that the exporters and the producers had essentially formed a common front *against* the reform: “la cadena, que es productor-intermediario-exportador, en ese momento hicieron un bloque y defendieron el statu quo, que no se modifique [el IVA] medida... hicieron un frente común” (AFIP A 2006, author’s interview). The former Minister of Economy also perceived that the exporters opposed the VAT reduction (Fernández 2006, author’s interview).

### ***Loosely Coordinated Opposition Despite Lack of Cohesion***

A united position against the VAT reductions in 1998 and loosely coordinated lobbying by the four producer associations also enhanced their ability to influence policy. Notably, this was the first time that the four producer associations had assumed a united stance on VAT policy. In 1989, the SRA and CRA recognized the advantages of including agricultural products in the general VAT regime, but CONINAGRO and the FAA preferred agriculture to remain exempt.<sup>27</sup> The smaller producers that these two associations represented had difficulty understanding the complicated technical logic behind the position in favor of extending the VAT to agricultural products. In addition, the accounting techniques required to keep track of the VAT were more costly for small producers to follow. An SRA advisor recalled that advocating inclusion in the VAT regime presented challenges even for the SRA, which represented the larger and better informed producers: “The President of the Rural asked me if I was sure of what I was saying because he would have to publicly explain that it was convenient for the producers to pay the VAT, and I told him: you have to explain that the producers should be part of the VAT chain. And he replied: I have a very difficult task...” (Former SRA 2006, author’s interview and translation). By 1998, however, producers had become more familiar with the technical logistics of the VAT. Consequently, leaders of the four associations found it easier to forge a common position against reducing the rate (Former SRA 2006, author’s interview). SRA editorials in *La Nación* may have helped align producers against the VAT reductions; these editorials constituted an active campaign to that affect. In addition, close relations between the technical advisors of the SRA, CRA, and CONINAGRO (author’s interviews: Landgraf 2006, CONINAGRO 2006), may have helped unify the associations’ positions. Although perceived common interests on this policy area were sufficient for the producers to loosely coordinate lobbying of the executive branch, fragmentation and heterogeneity remained a liability that curtailed the scope of the producers’ influence.

### ***Mechanisms and Limitations of Influence***

The policy process surrounding the VAT reductions illustrates the mechanisms through which the producers secured concessions as well as the limitations of their influence. The producers achieved success late in the policy process, given their modest instrumental power in a single policymaking arena, and the concessions they won ultimately depended on a contingent decision by President Menem.

The producers achieved little influence during the first stage of policymaking, which entailed obtaining authorization from Congress for the executive to reduce the VAT by decree, given the producers’ lack of instrumental power with respect to the legislature, as well as the cross-partisan consensus in favor of anti-evasion measures (Chapter 5). The opposition block in the lower house, consisting primarily of Radicals and Frepaso, endorsed the VAT reductions as a component of its own

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<sup>26</sup>For example, an unnamed informant from the export sector voiced this opinion at the end of June (*La Nación*, June 27, 1998), and a stronger statement by the president of the *Cámara de la Industria Aceitera de la República Argentina* (CIARA) was published in August (*La Nación*, Aug. 8, 1998).

<sup>27</sup>Although their technical advisors probably understood the advantages of inclusion in the VAT regime, these associations’ leaders opted to oppose the VAT, a position that resonated better with their membership base (Former SRA 2006, author’s interview).



political platform and voted in favor of the reform along with the PJ majority.<sup>28</sup> The proposal was quickly approved—the executive sent the bill to Congress in February and obtained authorization to draft the decree by the end of April.

In addition, lack of cohesion made the producers slow to coordinate their responses to the reform. When the measure was first announced at the beginning of January, the CRA and CONINAGRO expressed support, whereas the SRA voiced concern for the impact on grain producers.<sup>29</sup> These contradictory responses in part reflected the fact that the four associations had historically taken different positions on the VAT. The SRA worked to align the other producers associations behind its own position against the rate reductions. These efforts showed signs of success by mid-January; the CRA clarified that it would support a generalized VAT reduction but not a differential reduction for agricultural goods.<sup>30</sup> By the end of the month, the four associations were signing joint memos to the executive branch calling attention to the problem of unusable VAT credits.<sup>31</sup> Despite unification of positions and some coordination of actions, however, the executive moved the proposal forward without granting concessions; the Secretary of Agriculture at this stage deferred to the Economy Ministry and tax agency's position on reform.<sup>32</sup>

The producers were able to successfully enlist the Secretary of Agriculture's assistance during the second stage of policymaking, which entailed designing the details of the executive decree. In response to growing pressure from the producers, Solá facilitated joint meetings between the presidents of the four producer associations, tax agency director Carlos Silvani, Economy Minister Roque Fernández, and the Minister of the Presidency to give the producers opportunity to voice their concerns. While Silvani and Fernández held firm against the producers' demands, Solá proved an invaluable ally, seeking not only to advance the producers' interests but also to build his political reputation and assert his importance within the cabinet (Former SRA 2006, author's interview).

Although Solá did not convince Fernández or Silvani to soften the content of the original decree announced in May, Solá's position in favor of the producers ultimately prevailed. The first version of the decree reflected the tax agency's original intent; it did not reduce the VAT on inputs, nor did it permit producers to use their VAT credits against other tax obligations as the four producers' associations had requested.<sup>33</sup> However, Solá pushed hard to convince Menem to postpone enactment of the decree until July, at which point the 1998 harvest and commercialization process would be complete—a key objective for the producers that would temper the reform's impact.<sup>34</sup> Solá took advantage of a trip with President Menem to an agricultural exposition in Santa Fe during the second week of May to discuss at length the problems that the decree would cause for the producers and to arrange meetings between Menem and local producers.<sup>35</sup> The day before the decree was to take effect, after yet another meeting between the Economy Ministry, the tax agency director, and the producers ended without any promise of modifying the decree, Solá finally convinced Menem to postpone the reform. *La Nación* reported a rumor that Solá had even threatened to resign if the decree were enacted.<sup>36</sup> Menem's desire to avoid extended conflict with the producers before the inauguration of the SRA's annual Rural Exposition in July, at which he would deliver a keynote address, contributed to his decision to side with Solá.<sup>37</sup> After postponing the decree, Menem instructed the cabinet to work out a compromise solution with agriculture.<sup>38</sup> The

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<sup>28</sup>*La Nación*, March, 12, 2009. In the Senate, however, the Radicals voted against the reform, arguing that it was discriminatory and would hurt investment (*La Nación*, May 6, 1998). This reversal of position may have been motivated by contingent political considerations.

<sup>29</sup>*La Nación*, Jan. 8, 1998.

<sup>30</sup>*La Nación*, Jan. 13, 1998.

<sup>31</sup>*La Nación*, Jan. 29, 1998.

<sup>32</sup>Solá did not speak out against the VAT reduction until May. *La Nación*, May 14, 1998.

<sup>33</sup>*La Nación* May 12, 1998.

<sup>34</sup>*La Nación*, May 20, 1998.

<sup>35</sup>*Ibid*, *La Nación*, May 23, 1998.

<sup>36</sup>*La Nación*, May 23, 1998.

<sup>37</sup>*La Nación*, June 27, 1998.

<sup>38</sup>*La Nación*, May 20, 1998.

agreement reached at the end of June entailed exempting grains from the VAT reduction and reducing the rate on a few inputs and services.<sup>39</sup>

While the producers secured their primary objective, their success was by no means a foregone conclusion. One could imagine a plausible counterfactual in which Menem did not respond favorably to Solá's entreaties. Had the timing of events evolved differently, the Economy Ministry and the tax agency director, who defended the reform until the end, may have prevailed. Informal ties to the Secretary of Agriculture, a cabinet member who was not directly involved in tax policy formulation—even in combination with the latter's strong interest in advancing the producers' demands given his electoral ambitions—were a very modest basis for exerting influence on tax policy.

Not only did exempting grains from the VAT reduction entail a significant degree of contingency, but the producers were unable to block the VAT reform in its entirety, a goal advocated by a sizable rural constituency. Heterogeneity and organizational fragmentation prevented the producers from initiating effective collective action in pursuit of this additional concession. In the aftermath of the June compromise, the CRA affiliate CARBAP continued to protest the VAT reduction on meat, along with other aspects of the larger 1998 tax reform under discussion in Congress. CARBAP called for a production strike to coincide with the House of Deputies' committee hearings on the broader 1998 tax reform package.<sup>40</sup> The SRA openly opposed this initiative, calling it a "*disparate*" and reminding producers that "el Gobierno respondió a los dirigentes agropecuarios modificando el proyecto inicial de reforma del IVA agropecuario."<sup>41</sup> The SRA publicly expressed its satisfaction with the agreement reached with the government. CONINAGRO, like the SRA, declined to support the strike. The FAA declared that CARBAP's motivations for protesting were justified, but it also declined to participate.<sup>42</sup> And while the CRA also recognized the legitimacy of its member association's demands, the national leadership did not call for general participation in the strike.<sup>43</sup> Given limited participation and duration, the strike had a negligible economic impact and afforded no influence over tax policy.

### **The Success of the 2002 Reform Initiative**

Agricultural tax politics changed significantly after 2001. The economic crisis altered the power of the producers and the exporters; weakening the former and strengthening the later. In the context of crisis, the exporters strongly supported the reform, counterbalancing opposition from the producers. Accordingly, lobbying by the producer associations failed to prevent reduction of the VAT rate on grains in 2002.

### ***Producers' Weakened Structural and Instrumental Power***

The producers' structural power, which was already weak in 1998, declined as a result of the 2001 crisis. The end of convertibility and the devaluation of the peso created windfall profits for export crops and established agriculture as a relative winner in the new economic context. International prices for grains were increasing, and grain production was expected to reach new records, as announced regularly in the press throughout the year.<sup>44</sup> Producers' profits grew steadily; by one estimate, profits per hectare in 2002 were over 9 times the 1998-2000 average (Rodríguez and Arcea 2006: 7).<sup>45</sup> In this context, tax increases on agriculture were highly unlikely to alter producers' incentives; the producer associations' claims that higher taxation would hinder investment, decrease productivity, and effectively kill the goose

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<sup>39</sup>*La Nación*, June 27, 1998. As part of the agreement reached with the producers, the executive included the VAT reduction on grains in the larger tax reform package sent to Congress that year. However, the measure was ultimately removed. Congressional records are insufficient to determine exactly when and why this change came about, and informants did not recall the specifics.

<sup>40</sup>*La Nación*, July 18, 1998, July 24, 1998.

<sup>41</sup>*La Nación*, July 25, 1998.

<sup>42</sup>*La Nación*, July 25, 1998, July 30, 1998.

<sup>43</sup>*La Nación*, Aug. 3, 1998.

<sup>44</sup>See for example *La Nación*, Feb. 6, 2002, March 30, 2002, Aug. 3, 2002, Dec. 12, 2002.

<sup>45</sup>See Section II for a more detailed discussion of weak structural power.

that laid the golden egg<sup>46</sup> were not perceived as a credible threat of disinvestment. Moreover, if the government's economic team did not believe the producers would be left with unrecoverable VAT credits in 1998, they found that argument completely devoid of credibility in 2002. As the former tax agency director recalled: "bajar la alícuota en verdad prácticamente no perjudicaba a nadie... La renta que estaba obteniendo todos era importante, por que ellos tenían sus precios multiplicados por tres, y todavía tenían costos locales [en pesos]. Fue un momento que era propicio para modificaciones de este tipo," (Abad 2008, author's interview).<sup>47</sup> An SRA advisor recognized the producers' weakened position in retrospect: "los argumentos técnicos nuestros se habían debilitado, por el motivo de que había cambiado la relación precios-insumos en ese momento" (MacLoughlin 2008, author's interview).<sup>48</sup>

The producers' instrumental power declined as well, thanks to the new structure of authority within the executive branch brought about by the crisis. The Minister of Economy held unchallenged authority within the cabinet given the need to prioritize economic recovery. The President, like the Economy Minister, was highly unlikely to respond to efforts on the part of line ministries to promote their particular sectors' interests when so-doing ran counter to the fiscal needs of the state, given that the government urgently needed revenue to pay current expenditures and reestablish macroeconomic stability. The Secretary of Agriculture was therefore in a much weaker position to obtain tax benefits for the producers. As an informant from the grains sector observed, when the economy is not strong, the Secretary of Agriculture "no tiene peso;" following the crisis, "todo estaba subordinado a lo que decía el Ministerio de Economía," (Ravazzini 2006, author's interview). Accordingly, although the producers enjoyed informal ties to several of the individuals who served terms as Secretary of Agriculture during 2002, these informal ties were a less effective source of instrumental power than in 1998.

### ***Export Firms' Structural Power and Active Support for VAT Reduction***

The exporters supported the VAT reduction on grains much more actively in 2002 than they had in 1998. The government owed the export firms an onerous USD 800 million<sup>49</sup> in the aftermath of devaluation and dollarization of debt. From the exporters' point of view, VAT reimbursement arrears of this magnitude simply could not be tolerated in the context of numerous other obstacles to normal operation, including the *corralito* and associated restrictions on financial transactions, price instability, and generalized uncertainty with regard to economic policy. Although the exporters continued to assume a low profile in public, preferring not to openly confront the producers (author's interviews: Exporter B 2006, Exporter C 2008), AFIP negotiators perceived a clear difference from their attitude in 1998: "ahí notamos una ruptura. El sector exportador claramente quedó a favor nuestro... El sector exportador un poco se separa de esa presunta coalición o convenio que había hecho con el resto de la cadena, y apoya la

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<sup>46</sup>See for example Héctor Müller, "La amenaza impositiva," *La Nación*, Sept. 7, 2002. The article quotes the president of the SRA, who associated this and other tax reforms with recession: "ya no es factible aumentar los impuestos... ése es el camino que nos llevó a la recesión que luego no supimos revertir." Likewise, a CRA leader emphasized the economic importance of the agricultural sector, calling the VAT reduction "una confiscación de recursos de uno de los sectores más dinámicos de la economía nacional y aporta el mayor número de divisas por exportaciones." The same article continues in the same vein: "Se considera que esta reducción de la alícuota del IVA ventas será, en la práctica, como crear un impuesto adicional al productor que le provocará un perjuicio millonario, aniquilará las posibilidades de inversiones tecnológicas e impedirá el aumento de la producción."

<sup>47</sup>The tax agency's assertion that producers would not be left with substantial costs from unrecoverable VAT credits proved correct: "si veríamos la declaración jurada de los productores era todo saldo a pagar, por lo cual el 10.5% está en equilibrio. Lo que pasa es que seguramente esto obligó a que tuvieran que facturar más en blanco," (AFIP A 2006, author's interview).

<sup>48</sup>Notwithstanding this admission, the producers opposed the VAT reduction as strongly in 2002 as they had in 1998 (author's interviews: Ambrosetti 2008, MacLoughlin 2008). Despite their improved economic situation, the producers' technical advisors still held that lowering the VAT on grains would generate unrecoverable credits for certain producers in certain regions, and they opposed the reform on principle. Producers made clear their opposition to the VAT reduction quite clear; the measure was consistently listed along with the sector's other grievances in news coverage during 2002. See for example *La Nación*: March 9, 15, 26, 29, 30, 2002, April 10, 13, 30, 2002, May 17, 2002, June 6, 12, 2002, Aug. 3, 2002, Sept. 10, 11, 21, 2002, Dec. 27, 28, 2002.

<sup>49</sup>*La Nación*, Feb. 2, 1998.

medida de reducir [el IVA] al 10.5%,” (AFIP A 2006, author’s interview).<sup>50</sup> The former Minister of Economy, tax agency director, and Secretary of the Treasury all identified the exporters as the government’s allies with regard to the 2002 VAT reduction (author’s interviews: Lavagna 2006, Abad 2008, Lamberto 2006).

Moreover, the export firms wielded strong structural power in the aftermath of the financial sector collapse, which made addressing the VAT issue absolutely imperative for the government. There was a credible threat that failing to reimburse the exporters for their VAT credits could provoke grains “purchasing holidays,” a disruption of normal economic activities that could have had serious consequences for the economy more broadly. In the context of default and massive capital flight, grain exports were one of the country’s few sources of foreign currency. According to the Secretary of Agriculture, in early 2002, grain exports accounted for fully 60% of foreign exchange (*divisas*) entering Argentina.<sup>51</sup> If the exporters ceased to purchase and market grains, the government’s ability to reestablish solvency and achieve macroeconomic stabilization could have been jeopardized. The exporters did in fact stage periodic purchasing holidays during the first quarter of 2002 in response to the uncertainties and market problems associated with the end of Convertibility.<sup>52</sup> And the exporters frequently linked their actions explicitly to the problem of VAT reimbursement arrears.<sup>53</sup> The exporters’ structural power thus took the form of credible and occasionally realized, largely market-coordinated withholding threats.<sup>54</sup> While the government could not afford for the exporters to cease their operations, the government also could not afford to reimburse the exporters for VAT payments that had never entered state coffers. The VAT reduction therefore acquired a new urgency during the height of the economic crisis.

### ***The Producers’ Failed Attempts to Block Reform***

The 2002 policy process illustrates how the exporters’ structural power and the producers’ weakened instrumental power facilitated reform. Although the producers managed to delay approval of the reform during the final stages of its consideration in congress, they ultimately achieved little influence.

The exporters’ structural power helped place the VAT reform squarely on the agenda early in 2002. Purchasing holidays in January motivated the government to sign an agreement with the exporters promising to pay USD 590 million in nineteen installments—fully 74% of the amount the exporters asserted they were owed in VAT reimbursements. In exchange, the exporters agreed to sell a minimum of USD 100 million on the currency market during the following month.<sup>55</sup> Exporters explicitly threatened to withdraw from the grains market again if the government did not make good on its promises.<sup>56</sup> It was

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<sup>50</sup>It should be noted that an informant from an export firm asserted that the exporters’ role in 2002 did not differ significantly from their role in 1998: “No también tomamos una actitud de estar participando en el tema pero no impulsándolo ni siendo detractores autraces, un poco una actitud de abstención,” (Exporter A 2006). I have granted less weight to this assertion because this informant was not directly involved in the policy process.

<sup>51</sup>*La Nación*, Aug. 3, 2002. According to another estimate, exporters accounted for 56% of the foreign exchange absorbed by the Central Bank (*La Nación* Oct. 19, 2002). Although CIARA reports some information from its members on foreign exchange sales, records do not exist prior to 2002 (Exporter B 2006, author’s interview).

Such dependence on exporters for foreign exchange was by no means a new development in Argentina. As Viguera (2000: 34) observes: “los exportadores han tenido históricamente la capacidad de condicionar fuertemente las políticas y los equilibrios macroeconómicos por su control sobre el ingreso de divisas.”

<sup>52</sup>*La Nación*, Jan. 15, 17, 26, 29, 30, 2002, Feb. 2, 11, 2002, March 12, 2002, April 18, 2002.

<sup>53</sup>*La Nación*, Jan. 29, 2002: “Cereales: por las deudas que mantiene el Estado, se paralizaría el comercio de granos,” Jan. 30, 2002: “Cereales: persiste el conflicto por las deudas del Estado,” Feb. 2, 2002.

<sup>54</sup>The purchasing holidays may have involved an element of political coordination (instrumental power) as well. Export firms apparently discussed deliberately withdrawing from purchasing markets to give their demands force; as an export firm representative declared after a CIARA meeting: “La única forma de que nos escuchen es retirándonos del mercado,” (*La Nación*, Jan. 29, 2002: “Cereales: por las deudas que mantiene el Estado, se paralizaría el comercio de granos”). However, discussion of a capital strike ended with agreement that each firm would make its own purchasing decisions while CIARA attempted to negotiate a solution to the VAT problem with the government (*La Nación*, Jan. 30, 2002: “Cereales: persiste el conflicto por las deudas del Estado”).

<sup>55</sup>*La Nación*, Feb. 9, 2002.

<sup>56</sup>*La Nación*, Jan. 23, 2002.

in this context of pressing need to resolve the VAT arrears problem that the government formally initiated the reform proposal to lower the VAT rate on grains in February. Pressure from the exporters continued during the next three months. In May, the exporters complained that the state's VAT reimbursement debt had increased by USD 500 million, despite the fact that installments on previously incurred debt were being paid as arranged.<sup>57</sup> The *Cámara de la Industria Aceitera de la República Argentina* (CIARA) announced that its members had no alternative but to withdraw from marketing: "No es una amenaza, es la simple descripción de la realidad; las empresas no pueden seguir financiando al Estado."<sup>58</sup> This pressure from the exporters to resolve the arrears problem, as well as their greater support for the VAT reduction initiative itself, counterbalanced the producers' objections to the VAT decrease.

During this period, the producers failed to win concessions from the executive not only on the VAT measure, but also on a barrage of other policies that imposed higher costs on agriculture,<sup>59</sup> given their weakened instrumental power. Secretary of Agriculture Miguel Paulón advocated on the producers' behalf in multiple policy areas, including converting debt owed to the agro-input companies into pesos and lowering the rate of newly-introduced export taxes.<sup>60</sup> Some minor concessions were won on the former issue: debt owed by producers of perishable good for the internal market would be converted to pesos. However, the Economy Ministry publicly contradicted the Secretary of Agriculture's assertion that the decree dollarizing debt on inputs would be reviewed in full.<sup>61</sup> Tax policy, meanwhile, proved non-negotiable, given the state's dire need for revenue. Paulón resigned in April after failing to convince the Economy Minister and the President to reconsider the decision to double export taxes on grains.<sup>62</sup>

Given their lack of cohesion, the producers were unable to mount widespread collective action in order to lend force to their demands. The CRA and the FAA proposed a general production strike in April when it became clear that lobbying the executive was not yielding results.<sup>63</sup> Although the CRA and the FAA attempted to convince the SRA and CONINAGRO to participate, the later two associations declined the invitation, given their reluctance to engage in confrontational actions.<sup>64</sup> The producers' organizational fragmentation and heterogeneity also made it easy for the executive to divide and conquer, a strategy that was also quite effective at the cross-sectoral level (Chapter 5). Duhalde was able to drive a wedge between the FAA and the CRA by promising the FAA that he would announce a package of measures addressing their specific demands the following month.<sup>65</sup> In response, the FAA withdrew its support for the strike. CRA members were thus the only producers who participated in the short strike at the end of April. Duhalde's failure to make good on his promise to the FAA in May had few repercussions for the government. The FAA mounted its own strike in protest,<sup>66</sup> but like the CRA's earlier effort and CARBAP's 1998 strike, this action had little economic impact, given that the other producers' associations opted not to participate.<sup>67</sup>

Later in the year, when the VAT bill returned to the lower house of Congress for final approval, the producers' prospects for winning concessions were somewhat improved. The worst of the economic crisis had passed, export taxes were replenishing state coffers, and export firm purchasing holidays were a less likely prospect. In addition, the producers enjoyed strong informal ties to the new Secretary of

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<sup>57</sup>*La Nación*, May 22, 2002.

<sup>58</sup>*La Nación*, May 22, 2002. During these episodes of conflict, the government did not always immediately concede to the exporters' demands. For example, the government accused the exporters of failing to make sufficient foreign exchange available toward the end of February, Congress threatened to impose sanctions (*La Nación*, Feb. 25, 2002), and the Central Bank issued a resolution requiring the exporters to sell foreign exchange no later than five days after an operation had been completed (*La Nación*, March 27, 2002). However, structural power clearly enhanced the exporters' influence.

<sup>59</sup>These included dollarization of debt incurred with agro-input manufacturers, export taxes, and fuel price increases.

<sup>60</sup>*La Nación*, March 23, 2002.

<sup>61</sup>*Ibid.*

<sup>62</sup>*La Nación*, April 9, 2002, Aug. 10, 2002.

<sup>63</sup>*La Nación*, April 5, 2002, April 9, 2002, April 13, 2002.

<sup>64</sup>*La Nación*, April 19, 2002.

<sup>65</sup>*La Nación*, April 29, 2002, May 25, 2002.

<sup>66</sup>*La Nación*, May 17, 2002, May 25, 2002.

<sup>67</sup>*La Nación*, May 27, 2002.

Agriculture Harold Lebed. Lebed had family connections to producers and grain intermediaries and had developed close relationships with producers during his tenure as Minister of Agriculture in the provincial government of Buenos Aires.<sup>68</sup> Both Lebed and the Minister of Planning openly opposed the VAT reduction. Both officials asked Minister of the Economy Lavagna to abandon the measure,<sup>69</sup> and Lebed even lobbied deputies in Congress on behalf of the producers' interests.<sup>70</sup> Their efforts to oppose the measure from within the cabinet prolonged the debate and helped the producers make some inroads in Congress.<sup>71</sup>

However, the producers' advocates within the cabinet remained in a weak position to win concessions, given the top leadership's continued prioritization of revenue concerns, as well as continued pressure from the exporters for more timely VAT reimbursements.<sup>72</sup> President Duhalde supported the Minister of Economy, and the producers lost ground in Congress. Duhalde enjoyed strong support from the legislator—Congress had chosen him to be president following Rodríguez Saá's resignation—and the executive was able to align the legislators behind the proposal without difficulty (Lamberto 2006, author's interview). Lobbying against the VAT reduction in congress would have been a difficult task for the producers even had they enjoyed strong relationships with legislators. Legislators and the public perceived the VAT reduction on grains as a benefit for consumers; the bill therefore enjoyed high levels of support. In addition, given the technical complexity of the issue, the producers found it difficult to counter the common perception that reducing the VAT also benefited producers (Ambrosetti 2008 interview, author's interview).<sup>73</sup> The Minister of Economy secured the passage of VAT reduction in Congress in December, along with a host of other measures to increase tax revenue.<sup>74</sup>

## Overview

Figure 6.2.2 below summarizes the arguments presented in this section. In 1998, the producers' moderate instrumental power helped them block the VAT reduction on grains. However, the producers' instrumental power arose exclusively from informal ties, which tend to afford influence in a highly contingent manner. Further, the producers lacked structural power. As such, the producers may not have succeeded in the absence of two additional factors: a fortuitous convergence of interests with the Secretary of Agriculture, and the exporters' tacit alliance with the producers despite their preference for a lower VAT rate. In 2002, the executive was able to pass the reform. The producers' instrumental power had declined significantly; informal ties to the line-ministers were less effective given the enhanced authority of the Minister of Economy during the crisis period. In addition, the exporters' strong structural power during the height of the crisis, which made resolving the VAT arrears problem absolutely imperative, and their stronger support for reducing the VAT rate contributed to reform. Loose coordination among the producers' associations enhanced their lobbying effort in 1998 but proved insufficient for success in 2002 given the other factors that weighed in favor of reform.

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<sup>68</sup>*La Nación*, Sept. 23, 2002, *Clarín*, Aug. 10, 2002, *Clarín*, Aug. 17, 2002.

<sup>69</sup>*La Nación*, Oct. 4, 2002.

<sup>70</sup>Lebed met with legislators from the agriculture committee in order to formulate alternative proposals (*La Nación*, Sept. 23, 2002). In early October, he announced that he had reached an agreement with the head of the agriculture committee to postpone further discussion of the bill (*La Nación*, Oct. 2, 2002).

<sup>71</sup>*La Nación*, Dec. 14, 2002.

<sup>72</sup>*La Nación*, Dec. 12, 2002: "Modifican el IVA para los granos," *La Nación*, Dec 10, 2002: "Rebaja del IVA a los granos: Diputados trataría el proyecto para reducir la alícuota."

<sup>73</sup>Nevertheless, substantial debate did take place in the House of Deputies on the VAT reduction bill, with various legislators presenting the producers' arguments against the reform (*Diario de Sesión, Cámara de Diputados*, March 13, 2002, and Dec. 18, 2002).

<sup>74</sup>*Clarín*, Dec. 18, 2002.

**Figure 6.2.2: Producers' Power, Additional Causal Factors, and VAT Policy Outcomes**

		<b>1998</b>	<b>2002</b>
<b>INSTRUMENTAL POWER</b>		<b>MODERATE</b>	<b>WEAK</b>
	<b>Relationships with Executive Branch</b>	<b>Moderate</b> Informal Ties to Secretary of Agriculture	<b>Weak</b> Informal Ties Less Effective: Reduced Authority of Secretary of Agriculture within Cabinet
	<b>Relationships with Legislators</b>	<b>Weak</b> Absence of partisan linkages or extensive informal ties	<b>Weak</b> Absence of partisan linkages or extensive informal ties
	<b>Cohesion</b>	<b>Weak</b> Organizational Fragmentation, Heterogeneity	<b>Weak</b> Organizational Fragmentation, Heterogeneity
<b>STRUCTURAL POWER</b>		<b>WEAK</b>	<b>WEAKER</b>
<b>ADDITIONAL CAUSAL FACTORS</b>		<b>Against Reform:</b> Fortuitous Convergence of Interests with Secretary of Agriculture; Exporters' Tacit Alliance with Producers	<b>In Favor of Reform:</b> Exporters' Structural Power and Greater Support for Reform
<b>OUTCOME</b>		<b>REFORM FAILED</b>	<b>REFORM PASSED</b>

## II. Export Taxes

In 2002, after the collapse of the Convertibility regime and devaluation of the peso, the Argentine government established taxes on major agro-export crops at a rate of 10%. Rates on most agricultural exports were quickly increased to 20%. President Nestor Kirchner (2003-07) maintained the export taxes throughout his term and repeatedly increased the tax rates on soy and grains; the rate for soy reached 27.5% at the beginning of 2007 and was increased to 35% in November of that year.

Although agricultural producers vociferously opposed the export taxes from their inception, the producers were unable to deter the periodic rate increases that accompanied rising international prices from 2002 through 2007. Yet in 2008, the producers staged a series of massive protests that led to the demise of an export tax increase of similar magnitude to the previous reforms. This turn of events constituted a stunning political defeat for Nestor Kirchner's newly elected successor, Cristina Fernández de Kirchner (2008-present).

This section begins by discussing the multiple policy purposes served by the export taxes after the 2001 crisis, as well as their desirability as a revenue-raising tool from the executive's point of view. I proceed to explain export tax policy outcomes—namely, successful rate increases from 2002-2007 in contrast to failed reform in 2008—by analyzing variation in the producers' power over time (Figure 6.2.3).

From 2002 to March 2008, the producers were unable to exert influence over export taxes, a policy area of manifest importance to the government, given their weak structural and instrumental power. Structural power was weak given the high profitability of agricultural commodities despite the taxes; the producers' claims that export tax increases would harm investment and production were patently non-credible. Instrumental power was weak given the producers' lack of cohesion and the absence of favorable relationships with policymakers. As such, the producers' weakly coordinated lobbying secured no concessions, and they could mount only brief, small-scale, and therefore ineffective protests. In addition, the executive managed opposition by employing a variety of tax-side and benefit-side strategies. In contrast to the producers, the exporters were able to place some limits on export tax policy during the first trimester of 2002, thanks to their structural power during the height of the crisis. Thereafter, however, the exporters ceased to play a role in export tax politics given that the firms did not bear the direct cost of these taxes.

However, the new and impolitic design of the 2008 export tax reform pushed producers' grievances, which had accumulated in multiple policy areas, past a threshold of tolerance, thereby facilitating collective action despite the producers' prior lack of cohesion. In this context, the producers were able to stage a series of lengthy and massive protests, of which capital strikes were the most important component. The reform and the protest it provoked enhanced cohesion, and hence strengthened instrumental power, by motivating the producers to take steps toward organizational unification. Enhanced cohesion in turn facilitated continued protest and allowed the producers to more effectively coordinate lobbying in formal policymaking venues. Facing a cohesive producers lobby and heavy economic and political costs inflicted by the capital strikes, the government was forced to make multiple concessions that culminated in the repeal of the 2008 reform.

The 2008 conflict had lasting effects. The producers emerged as a consequential political actor with new sources of instrumental power. Cohesion was institutionalized through consolidation of an encompassing organization, and the producers began to cultivate relationships with political parties in order to augment their influence in the legislative arena.

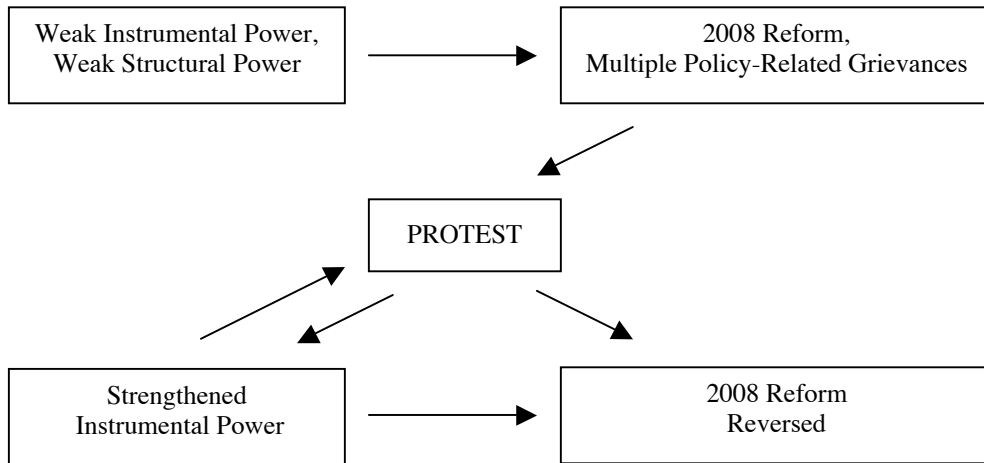


**Figure 6.2.3. Producers' Power, Protest, and Export Tax Policy, 2002-2008**

**A. Sources of Power**

	2002-March 2008	March-July 2008
<b>Instrumental Power</b>	<b>Weak</b> Lack of Cohesion, Weak Relationships with Policymakers	<b>Strong</b> Increased Cohesion
	Societal and Economic Arenas: Small, Brief Protests	Formal Policymaking Arenas: Uncoordinated Lobbying
		Societal and Economic Arenas: Massive, Sustained Protests
		Formal Policymaking Arenas: Coordinated Lobbying
<b>Structural Power</b>	<b>Weak</b> No Credible Threat of Market-Coordinated Disinvestment	<b>Weak</b> Withholding is Not Market-Coordinated
<b>Outcome</b>	<b>Taxes Increased Periodically</b>	<b>March Tax Increase Retracted</b>

**B. Causal Diagram**



## The Multiple Purposes of Export Taxes

Export taxes are a policy tool that has been used periodically in Argentina in conjunction with exchange rate devaluations since 1866 by governments of diverse ideological orientations, during military rule and democracy alike (Treber 2004: 16, Nogués et al 2007: 24).<sup>75</sup> Following the 2001 crisis, export taxes served multiple purposes. Not only were the taxes a major source of revenue for the central government, they also helped control consumer prices for food staples, contributed to industrial policy, and redistributed wealth from the countryside, which benefited greatly from devaluation, to urban sectors.

Export taxes were highly effective for raising revenue in the aftermath of the crisis. These taxes are easy to administer and difficult to evade. The revenue is collected directly from export firms, a relatively small pool of taxpayers that can easily be monitored; moreover, exports pass through a small number of ports that are easily controlled. These taxes therefore effectively extracted revenue from agriculture, a sector that historically had very high levels of tax evasion. Moreover, the export taxes tapped windfall profits associated with devaluation of the peso and increasing commodity prices after the demise of Convertibility. Thanks to the combination of an undervalued peso and high international prices for agricultural commodities, export taxes remained a key source of revenue throughout Kirchner's term. Between 2003 and 2007, export taxes generated an average of 12.5% of total tax revenue collected by the central state.<sup>76</sup> Export tax revenue helped to reestablish fiscal solvency after the 2001 and subsequently helped sustain the fiscal surplus, which was regarded as critical for preserving stability.

Export taxes were a particularly desirable revenue-raising tool from the central government's perspective due to institutional incentives created by rules governing the distribution of revenue between the central and provincial governments, and the executive branch's legislative prerogatives. First, revenue from export taxes was not shared with the provinces. This characteristic distinguished export taxes from almost all other taxes collected by the central state in Argentina, for which revenue was automatically divided between the central government and the provinces according to fixed percentages legislated in the Senate (Saiegh and Tommasi 1999: 176-7). Although the export taxes amounted to an average of only 12.5% of total tax revenue collected by the central state from 2003 to 2006, they constituted on average 18.4% of the tax revenue retained by the central government.<sup>77</sup> This revenue contributed to fiscal stability; the provinces' capacity to secure substantial shares of revenue collected from internal taxes had been a recurrent problem for governments faced with budget deficits in the 1990s (Spiller and Tommasi 2007: 105-120). Export tax revenue also enhanced the Kirchner administration's ability to maintain alliances with provincial governors through discretionary allocation of funds.<sup>78</sup> Second, the constitution granted the executive authority to legislate export taxes by decree (Saiegh and Tommasi 1999: 176). The president could therefore enact rate increases at will, bypassing debate in Congress. After 2005, when Kirchner's leadership consolidated and his coalition won a majority in Congress (Etchemendy and Garay 2008: 10), legislative approval for export tax increases would not have been difficult to obtain. However, legislative participation in export tax policymaking would have required more time and, more importantly, may have opened the door to demands for revenue sharing with the provinces.<sup>79</sup>

Beyond revenue concerns, export taxes on wheat and meat acted to suppress prices for these basic consumer goods and thereby helped contain the growth of poverty following the crisis (Di Gresia 2006).

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<sup>75</sup>Leaders who applied export taxes included Radical presidents Frondizi (1958), Illia (1965), and Alfonsín (1987). Under the Onganía dictatorship, Economy Minister Kreiger Vasena devalued the peso by 40% and compensated the measure by applying export taxes of 20 to 25% (1967). Military governments under Levingston, Lanusse, and during the last military junta (1982) maintained export taxes as well (*Página 12*, May, 18, 2008). Perón of course heavily taxed agriculture as well, through state-owned marketing boards as well as other mechanisms (See for example Ascher 1984: 54-55).

<sup>76</sup>Source: DNIAF, excluding social security taxes. The Central Bank actively purchased foreign exchange to maintain the high exchange rate, especially during 2007 (Richardson 2009).

<sup>77</sup>Author's calculations based on DNIAF: Recursos Tributarios annual tables.

<sup>78</sup>See for example Levitsky and Murillo (2008: 19), Richardson (2009: 244) and *La Nación*, March 23, 2008.

<sup>79</sup>A similar dynamic occurred with tax bills in the 1990s. Eaton (2002) details how senators were regularly able to amend tax legislation to obtain higher percentages of revenue for the provinces, despite the fact that Menem enjoyed a majority in both houses of Congress.

Argentina is a major exporter of wheat and meat, which are also key wage goods, so when these exports become more profitable, domestic prices rise accordingly. Export taxes had historically been used to control inflationary pressures when devaluation or high international prices stimulated wheat and beef exports.<sup>80</sup> Di Gresia (2004: 8, 10), a Universidad de la Plata economist who consulted for the Economy Ministry during Nestor Kirchner's presidency, estimated that immediate inflationary affects associated with removing the export taxes in 2003 would have increased poverty from 49% to 53% and indigence from 20.5% to 25.6% of households.<sup>81</sup> As a consequence, one million individuals would have fallen into poverty, and 1.2 million poor people would have become indigent (Di Gresia 2004: 16).<sup>82</sup>

The export taxes were also a key component of Kirchner's industrial policy. Export taxes stimulated agro-industry by depressing the prices of inputs (Rodriguez and Arceo 2006: 6) and by equalizing export incentives for primary products and processed products:

La competitividad del sector agroexportador en la Argentina es de tal magnitud que impediría que se desarrollara cualquier industria exportadora... entonces las retenciones a la exportación, ... hacen que el sector agroexportador tenga un tipo de cambio mas bajo y pueda equilibrarse el tipo de cambio del sector industrial. (Di Gresia 2006, author's interview).

Because agro-industry made an important contribution to employment, removing the export taxes could have resulted in a significant loss of jobs (Di Gresia 2006, author's interview).<sup>83</sup> Export tax revenue was also used to subsidize domestic industries (Etchemendy and Garay, forthcoming, Richardson 2009).

To a significant extent, then, the export taxes served as a redistributive tool that harnessed resources from the countryside, which profited greatly from the change of economic model, for the benefit of urban sectors hard-hit by the crisis. Many experts interviewed for this project, including both heterodox and orthodox economists, in fact viewed the export taxes as a progressive policy instrument.<sup>84</sup> As an orthodox economist explained: "como hay mucho de tierra en esto... y la tierra no se puede mover... la tierra normalmente no la tiene los pobres, por lo tanto puede ser que tenga un componente progresivo," (Artana 2006, author's interview).<sup>85</sup> However, two caveats should be kept in mind regarding the distributional incidence of the export taxes. First, although the bulk of the tax burden probably fell on landowners, who tended to belong to upper-income groups, both large and small producers were affected by the taxes. Second, the domestic price reductions created by the export taxes amounted to a generalized subsidy, benefiting upper and middle-income sectors along with the poor.<sup>86</sup> Therefore, while the export taxes probably had progressive affects, revenue extraction was not especially targeted at upper income groups, nor were benefits highly targeted to low-income groups. By 2007, moreover, some economist

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<sup>80</sup>Keeping these basic foods cheap was imperative for populist governments seeking to promote industrialization and construct political alliances with workers and protected industries, although periods of export restrictions (through export taxes or other policies including overvalued exchange rates, quotas, or control by state-owned marketing boards) usually ended in balance of payments crisis (O'Donnell 1978, Richardson 2009).

<sup>81</sup>According to a different source, removing the export taxes in 2004 would increase indigence from 10.7% to 13.7% and poverty from 29.8% to 35.6% of households (CENDA 2005: 7).

<sup>82</sup>The more involved general equilibrium analysis conducted by Nogués et al. (2007: 87-88) using 2006 data finds smaller affects for eliminating export taxes. Poverty was expected to increase immediately from 24.6% to 27.2%, and indigence from 7.3% to 9.1%. After a period of about three years, wage increases associated with increased producer prices would compensate these negative affects. Poverty was expected to stabilize at 23.7%, and indigence would return to 7.4%, essentially equivalent to its initial value 7.4%. Note that poverty had improved significantly between 2003 and 2006, making the context of the 2007 study and Di Gresia's 2004 study significantly different.

<sup>83</sup>Nogués et. al (2007:109) in contrast find that eliminating the export taxes and other export restrictions in 2006 would have created between 300,000 and 350,000 additional jobs.

<sup>84</sup>Informants holding this opinion included heterodox economists (Sabaini 2006, author's interview, Treber 2004), orthodox economists (Artana 2006, author's interview), government economic advisors (author's interviews: Di Gresia 2006, MECON A 2006), and the former Economy Minister (Lavagna 2006, author's interview).

<sup>85</sup>The informant noted however that determining incidence requires a careful analysis of the entire production chain. To my knowledge, no economically rigorous incidence studies of export taxes were conducted prior to 2007. For an in-depth analysis of the affects of removing the export taxes based on a general equilibrium model, see Nogués et al. (2007).

<sup>86</sup>A study based on 2006 data asserted that 70% of this general subsidy benefited the top five deciles (Nogués et al 2007: 233).

asserted that the impact of eliminating the export taxes on poverty levels had decreased substantially and that reducing the taxes would stimulate growth and job creation over the medium term (Nogues et al 2007).

### **Weak Structural and Instrumental Power Facilitate Tax Increases, 2002-2008**

Prior to 2008, producers in Argentina enjoyed neither instrumental power nor structural power. As such, they were unable to either influence the government's export tax agenda or win substantial concessions after new export tax increases were announced. Policymakers were confident that the tax increases would not affect investment or production, the producers' lobbying efforts were ignored, and their efforts to mount large-scale collective action failed.

#### ***Producers' Weak Structural Power***

The producers' structural power was weak from 2002 through 2008. Despite the high export taxes, production remained very profitable, due to the devalued peso as well as high international prices (Figures 6.2.4-6). Average profits per hectare between 2002 and 2004 were more than twice the average from 1991 to 2001 (EIU 2004: 31).<sup>87</sup> Soy profits were particularly high, although they declined at the end of 2004 due to increasing input costs and a dip in international prices. Figure 6.2.5 illustrates the change over time in soy profit margins (Ciappa 2005). Even the nearly 8 percentage point November 2007 tax increase did not alter the upward course of profits over the following months. Profit margins on the eve of the March 2008 tax increase remained well above their values from the previous year.

Despite the producers' complaints about the export taxes, they benefited tremendously from the undervalued peso, which probably would not have been sustainable without the export taxes (Di Gresia 2006, author's interview). Rodriguez and Arceo (2006: 8) estimate that producers' profits would have been on average 55% lower in 2003 and 2004 if the exchange rate had remained one to one as under Convertibility in the 1990s.<sup>88</sup> The authors also calculate effective export tax rates that, in combination with a higher exchange rate (using the 2004 value of about 2.9), would have had the same effect on producers' profits as the overvalued peso during Convertibility.<sup>89</sup> The average calculated equivalent export tax rate from 1991-2000 was 35% (Rodriguez and Arceo 2006: 14),<sup>90</sup> significantly higher than the rates that prevailed from 2002-2007.

Under these circumstances, producers clearly faced economic incentives to continue investing and producing, and policymakers anticipated that production would continue to grow despite the export tax increases. A high-level Economy Ministry official, for example, confidently asserted that the export taxes did not alter investment behavior, although he acknowledged that the financial transactions tax, another important revenue-raising tax, was in fact distortionary (MECON A 2006, author's interview). The government's statements in the press expressed similar convictions.<sup>91</sup> For example, Economy Ministry officials asserted with regard to a 2007 export tax increase that "aún después del aumento de las retenciones, la rentabilidad del sector productivo seguirá siendo adecuada para continuar con su desarrollo."

Production data indicate that in the case of soy, the most profitable crop, policymakers' perceptions were correct. Soy production increased from 26.9 million tons to 47.5 million tons from 2001 to 2007 (Figure 6.2.7).<sup>92</sup> Wheat production did not fare as well, due partly to a battery of state interventions after 2005, including price controls and closure of exports, as well as increasing input costs after 2004 (Nogués

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<sup>87</sup>Increasing land prices served as another indication of high profitability despite taxation (Treber 2004: 20, Miceli 2008, author's interview).

<sup>88</sup>Treber (*Clarín*: March 16, 2008) estimated that if the export taxes were eliminated and the exchange rate were to appreciate to Brazilian levels (1.7 instead of 3.17), soy producers' profits would be 16% lower. Different methodology and different years may explain the discrepancy in the magnitude by which profits are expected to decrease.

<sup>89</sup>The authors conduct this analysis applying the 2004 exchange rate for 1991-2000.

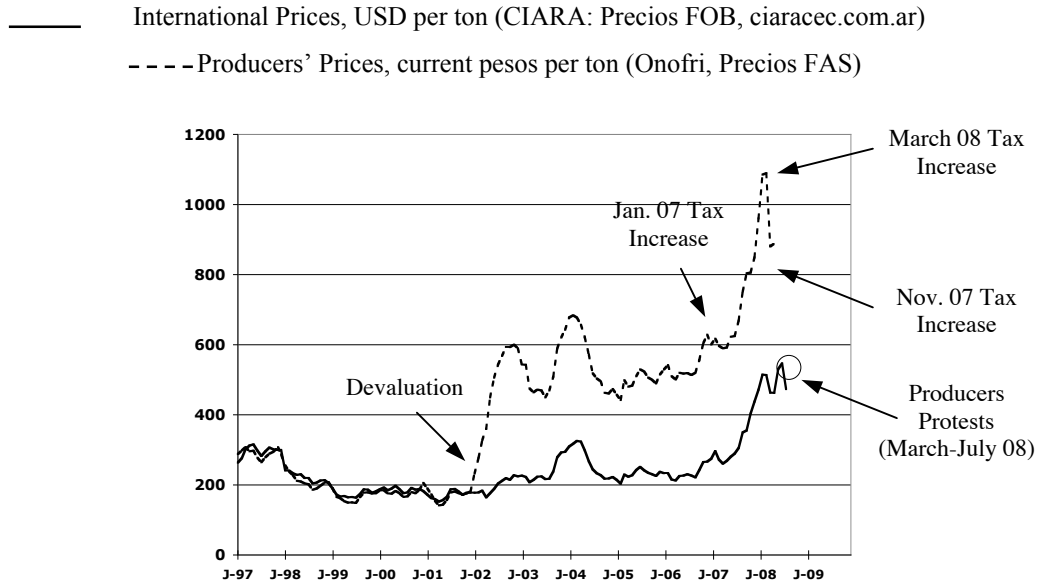
<sup>90</sup>A CONINAGRO estimate arrived at an even higher equivalent export tax rate of 40% (Sidicaro 2002: 200).

<sup>91</sup>*La Nación*: Jan. 12, 2007: "La alta renta del agro, en la mira de Miceli," by Martín Kanenguiser.

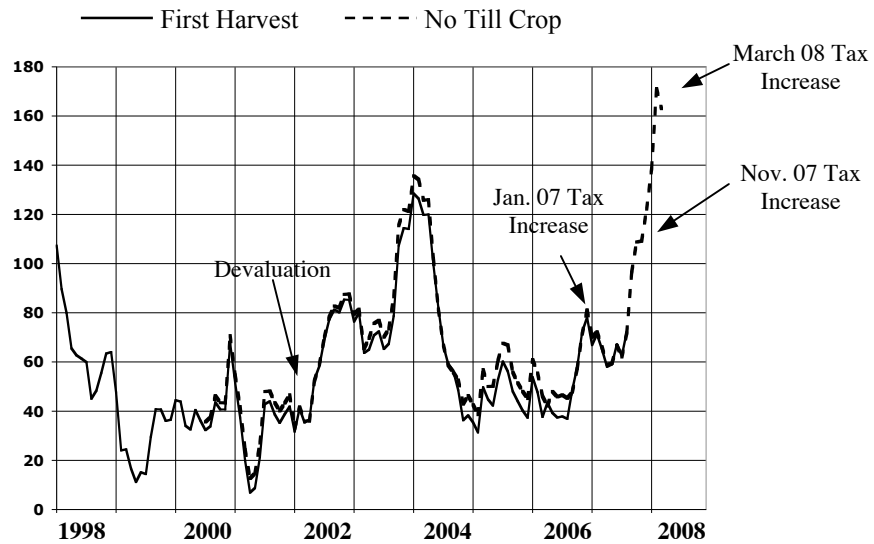
<sup>92</sup>Meat production declined as well for similar reasons.

et al 2007, Ciappa 2005). Figure 6.2.8 illustrates total production of cereals and oil-producing seeds from 1991 to 2004.

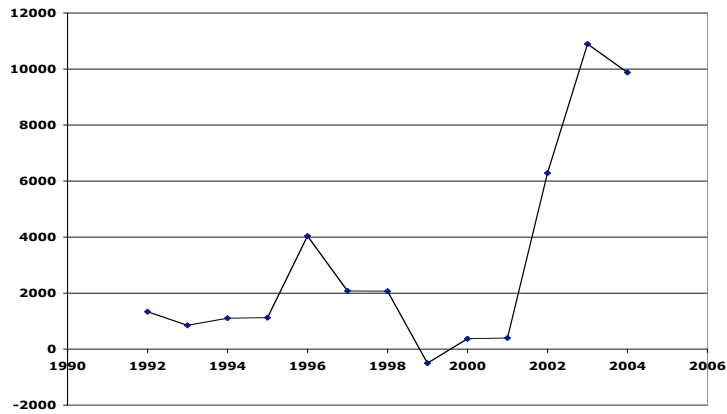
**Figure 6.2.4: Soy prices, Jan 1997 – May / July 2008.**



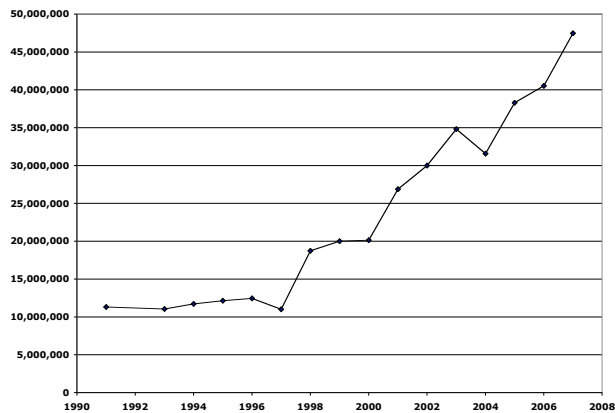
**Figure 6.2.5: Producers' Profits: Soy, USD/ton, Jan 1998-Jan 2008.** Source: Ciappa 2005: 23-24.



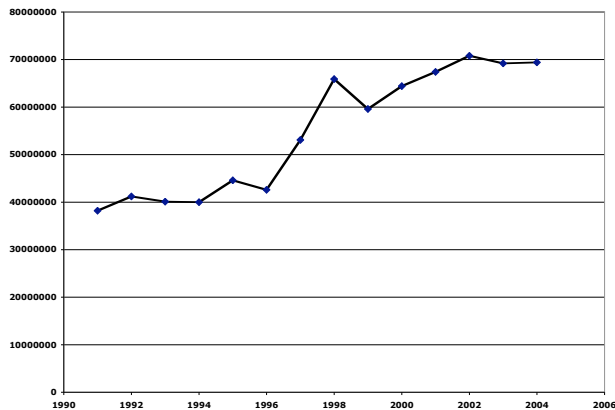
**Figure 6.2.6: Producers' Profits: Grains and Oil Seeds, 1992-2004**  
 (Constant 2004 prices, Millions of pesos)  
 Source: Rodriguez and Arceo 2006: 7.



**Figure 6.2.7: Soy Production (Tons), 1991-2007.**  
 Source: CIARA, www.ciaracec.com.ar



**Figure 6.2.8: Production of Cereals, Soy, and Oil Seeds, 1992-2004 (Millions of tons)**  
 Source: Rodriguez and Arceo 2006: 15.



### ***Producers' Weak Instrumental Power***

Not only was the producers' structural power weak, but they continued to lack sources of instrumental power with which to influence policy. Relationships with the executive branch, which held exclusive authority over export tax policy, remained weak after 2002. The producers lacked informal ties to cabinet members during the Kirchner administrations. Moreover, Kirchner maintained tight control over his cabinet and tended to delegate less decision-making authority on economic policy than Menem, who granted his Economy Ministers significant autonomy (Guidotti 2006, author's interview). Kirchner was centrally involved in defining economic policy, and both he and his finance minister, Lavagna, were strong advocates of export taxes. Accordingly, the Secretary of Agriculture upheld the policy decisions defined by the president and finance minister and did not advocate in favor of the producers' interests.<sup>93</sup>

Frequent changes in the official designated as the agricultural sector's interlocutor further weakened the producers' relationship with the executive branch. As one producer association informant observed: "te cambian el interlocutor todo el tiempo ...de repente te ponen al Sub-Secretario de Agricultura, de repente te ponen al Secretario de Comercio, ahora te ponen al Ministerio de Economía," (CRA 2006, author's interview). This tactic hindered development of strong working relationships between producers and cabinet members that might have afforded the producers a stronger voice in policy formulation. The producer associations attributed their weakness to the instability of relationships with executive branch officials as well as Kirchner's top-down control over his cabinet. For example, an editorial in *La Nación* lamented: "En el Gobierno no hay interlocutores válidos, salvo los canales informales. Las decisiones pasan exclusivamente por el presidente Kirchner. Ya no sólo es la Secretaría de Agricultura la que no tiene relevancia en este conflicto sino también el Ministerio de Economía."<sup>94</sup> Similarly, an SRA informant asserted: "Este gobierno es muy unipersonal, muy presidencialista... Con lo cual es muy difícil poder llegar así a dialogar," (Landgraf 2006, author's interview).

Kirchner, meanwhile, had little interest in accommodating the producers. His antagonism toward the agricultural sector may have rallied political support among the Peronist base—Peronism traditionally had viewed the SRA as symbolic of the rural oligarchy. In contrast to Menem and in defiance of historical precedent, Kirchner consistently ignored the SRA's invitations to preside at the inauguration of the annual Rural Exposition in Palermo. A Sociedad Rural informant observed that Kirchner perpetuated the misconception that Peron had never attended the Rural Exposition inauguration (MacLoughlin 2008, author's interview).<sup>95</sup>

Lack of cohesion due to organizational fragmentation and heterogeneity of interests continued to undermine the producers' ability to engage in collective action and to weaken their bargaining position with respect to the executive. The producer associations in fact held different opinions on export tax policy. The SRA and CONINAGRO rejected the export taxes on principle, whereas the FAA was more open to accepting the taxes if the revenue were spent in a way that included benefits for small producers (author's interviews: SRA A 2006, CONINAGRO 2006). Even during the height of the 2008 conflict with the government over tax increases on soy, the FAA president asserted that the export taxes were a legitimate redistributive tool, despite his disagreements regarding the details of their design and use.<sup>96</sup> Meanwhile, the four associations continued to disagree on the appropriateness and effectiveness of producers' strikes.

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<sup>93</sup>In fact, high-level AFIP informants noted a greater alignment between the Secretary of Agriculture and the tax agency in the 2000s as compared to the 1990s (author's interviews: AFIP A, D, E 2006).

<sup>94</sup>*La Nación*, March 25, 2006.

<sup>95</sup>The informant asserted that Peron had in fact attended the event on at least one occasion. On several occasions Kirchner did not even send a member of the cabinet in his place.

<sup>96</sup>*Perfil*, May 25, 2008. In response to the reporter's query as to whether or not Buzzi agreed that the export taxes should continue to exist, he responded: "Sí, porque es un instrumento de redistribución. La cuestión es cómo se diferencia la mediano y pequeño productor de modo que también sea un instrumento de redistribución intrasectorial. Hay una renta extraordinaria porque hay condiciones internacional y porque hay una política cambiaria que habilita un dólar de tres pesos y pico. Esa renta extraordinaria debe ser capturada y trasladada al conjunto de la sociedad."

Although communication among the four associations improved during the last years of Kirchner's term, when producers' frustrations grew in the context of multiple state interventions in agricultural markets, the four associations did not engage in coordinated collective action. In July 2006, for example, the CRA called for a strike to oppose beef policy; Kirchner had halted meat exports for 180 days in May (Nogués 2007: 27) and implemented various other policies intended to increase domestic supply and suppress domestic prices that antagonized cattle producers.<sup>97</sup> CRA producers refrained from selling their cattle for a number of days, but the other producers associations declined to participate in the strike. Although the volume of cattle entering the Linears market in Buenos Aires declined, the economic consequences of this and previous small-scale, short-lived producers' strikes were predictably insignificant and transitory (author's interview: Abad 2008, Miceli 2008).<sup>98</sup> Given their lack of cohesion, the producers simply could not engage in collective action on a large enough scale to mount an effective capital strike. Moreover, staff members from the SRA (A 2006, author's interview),<sup>99</sup> CONINAGRO (2006, author's interview) and even the CRA (A 2006, author's interview) asserted that the strike had been counterproductive. The government had been considering a reduction of export taxes on milk before the strike; however, the reduction was delayed (SRA A 2006, author's interview),<sup>100</sup> and conversations with producers regarding a cattle production-stimulus plan essentially ended (CRA A 2006, author's interview). Press reports and agricultural sector informants interpreted these developments as deliberate government actions to punish the producers for the strike.<sup>101</sup> In the words of a CRA staff member: "estamos en penitencia, estamos castigados por haber hecho el paro," (CRA A 2006). Like the SRA and CONINAGRO informants, he acknowledged that the strike had achieved nothing in terms of influencing policy: "hubo que generar una medida de fuerza, más que nada para llamar la atención, porque el paro desde el punto de vista práctico no tiene muchos efectos," (CRA A 2006, author's interview).

Finally, the producers had no allies outside of the agricultural sector to lend force to their complaints. Most of the private sector sympathized with the producers to the extent of agreeing that the export taxes were distortionary and needed to be eliminated in the medium-term; however, other distortionary taxes like the financial transactions tax were of much greater concern for the rest of the business community (Artana 2006, author's interview).<sup>102</sup> Moreover, the *Asociación Empresaria Argentina* (AEA), an association of influential large business owners founded in 2002,<sup>103</sup> and other private sector leaders outside of agriculture recognized that eliminating the export taxes would have an immediate negative impact on the fiscal surplus, which was important for macroeconomic stability. For that reason, the AEA's executive director publicly affirmed the necessity of the export taxes in 2005.<sup>104</sup> In addition, the government spent export tax revenue in ways that benefited industry. For example, in January 2007, the government created a subsidy for flour millers financed by an increase in the export tax rate on soy (Nogales 2007:32, Richards 2009).<sup>105</sup> The export tax increases also funded subsidies for the poultry and dairy industries. Lack of support for the producers from the broader business community was not surprising given the absence of a strong economy-wide encompassing association and the general lack of business class solidarity.

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<sup>97</sup>*La Nación*, Nov. 21, 2006.

<sup>98</sup>Former Finance Minister Miceli (2008, author's interview) described these small strikes as "una cosa casi simbólica. No fue algo importante."

<sup>99</sup>"Este paro agropecuario que se hizo fue un paro mal hecho, en un momento malo que no sirvió para nada." (SRA A 2006, author's interview)

<sup>100</sup>See also *La Nación*, July 18, 2006, July 20, 2006.

<sup>101</sup>*La Nación*, July 20, 2008.

<sup>102</sup>See also *La Nación*, June 13, 2005.

<sup>103</sup>The AEA's members jointly accounted for sales of over 200,000 million pesos and 10,000 million dollars of exports (www.aeanet.net). Members included Techint, Clarin, Volkswagen, and Coto, along with two agroexporters: Los Grobo and Aceitera General Deheza.

<sup>104</sup>*La Nación*, Aug. 13, 2005. The head of the AEA stressed the association's strong support for the fiscal surplus in an interview with the author (AEA 2006, author's interview).

<sup>105</sup>*La Nación*, Jan. 12, 2007: "Amplio rechazo de los ruralistas y respaldo de los industriales," by María Martini.



### ***Executive Strategies for Managing Opposition***

Although producers were in a weak position to demand concessions on export taxes given their weak instrumental and structural power, their opposition was intense and visible, especially after 2005. The government employed various tax-side and benefit-side strategies to manage the producers' opposition, including informally linking tax increases to social spending, vertical equity appeals, and granting selective compensations to particular actors in the production chain. The last strategy reproduces at the sectoral level the common Argentine approach of dividing and conquering the opposition to cross-sectoral taxes (Chapter 5). In addition, the government sought to counteract opposition from the producers by mobilizing popular sector supporters.

Informally linking the export taxes to social spending helped to delegitimize the producers' complaints when the taxes were first implemented in 2002. Decree 11/2002 explicitly cited social needs as a motivation for applying the taxes: "el actual contexto económico se caracteriza, entre otros aspectos, por un fuerte deterioro en los ingresos fiscales, que a su vez se encuentra acompañado por una creciente demanda de asistencia para los sectores más desprotegidos de nuestro país." Export tax revenue was not formally earmarked to social spending; however, the Duhalde administration announced that part of the expected additional revenue of USD 1400 million would fund social programs, which would eventually reach two million unemployed workers.<sup>106</sup> President Duhalde announced in April that revenue raised by increasing export tax rates to 20% would be used to expand social assistance to unemployed heads of households.<sup>107</sup>

The Kirchner administration continued in a similar vein. Government officials make ample use of vertical equity appeals. For example, Finance Minister Miceli asserted that the export taxes "redistribuir el ingreso mediante el aporte de los que más tienen y se encuentran beneficiados por los precios internacionales."<sup>108</sup> Similarly, Chief of Cabinet Alberto Fernández asserted that the export taxes extracted resources from the well-off when he asserted: "Las retenciones son un mecanismo redistributivo importante que permite que aquel que produce en pesos y vende en dólares participe con su comunidad las utilidades que tiene."<sup>109</sup> The producers associations were well aware that this redistributive framing placed them at a disadvantage by legitimating the export taxes in the eyes of the public. In the words of a CRA informant:

Que le sacan al rico para darle al pobre, es el mensaje que el Presidente traslada y es lo que el ciudadano –en general– está convencido. Sobre todo el ciudadano de Buenos Aires o del Gran Buenos Aires... Si bien no lo dice directamente así, en realidad, el mensaje que hay atrás de eso es un poco eso: "No voy a dejar que exporten o ganen plata a costo del hambre del pueblo argentino." ...Y eso, popularmente, le significa apoyo de la población. (CRA A 2006, author's interview)

The administration also continued to informally link export tax increases to popular benefits. For example, the government announced that revenue from a January 2007 tax increase would fund subsidies for food staples including bread, beef, and chicken.<sup>110</sup>

Given the producers' lack of cohesion, the government could diffuse conflict on export taxes and other agricultural issues by dividing and conquering. The government could negotiate with each association separately and/or offer benefits to small producers to preclude formation of a united opposition front (Miceli 2008, author's interview). Refinancing small producers' loans incurred with the Banco Nación in 2004 won Kirchner support from the FAA, and promises to resolve small producers' problems in other areas such as milk production also helped to contain conflict over export tax increases in early 2007 (Miceli 2008, author's interview). And as long as long as the government held out the

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<sup>106</sup> *Clarín*, March 5, 2002, *Clarín*, March 30, 2002.

<sup>107</sup> *Clarín* April 4, 2003, *Clarín*, April 5, 2002. This revenue contributed to funding for *Plan Jefes y Jefas de Hogares*, which effectively reached low-income households headed by unemployed or informal sector workers (Garay 2007: 313).

<sup>108</sup> *La Nación*, Jan. 12, 2007: "La alta renta del agro, en la mira de Miceli," by Martín Kanenguiser.

<sup>109</sup> *La Nación*, Nov. 7, 2007.

<sup>110</sup> *La Nación*, Jan 11, 2007: "Suben las retenciones a la exportación de soja para subsidiar alimentos," *La Nación*, Jan. 12, 2007: "La lucha contra la inflación: nueva medida del Gobierno," by Fernando Bertello.

possibility of negotiating compromises, the SRA and CONINAGRO were unlikely to engage in protest with the other associations, given their view of strikes as an ineffectual last resort. At worst, the government could expect that the CRA and/or the FAA might call a strike for a few days that could easily be ignored.

The Kirchner administration also employed a more confrontational strategy for managing opposition to the export taxes and other agricultural policies—mobilizing his popular sector supporters against the producers. Early in his administration, Kirchner had responded to the policy demands of politically unaligned unemployed workers associations, which had staged recurrent protests, especially in the aftermath of the 2001 crisis (Garay 2007). By extending social spending plans for unemployed heads of households, he won the loyalty of the largest of these associations. Thereafter, he was able to channel popular mobilization to his own ends (Etchemendy and Garay 2008: 7). In 2006, for example, Kirchner called on citizens to help him enforce price agreements negotiated with members of the beef production chain: “Si la carne está cara, que bajen el precio. Que el pueblo me ayude para que todos los argentinos tengan acceso. Basta de sectores de privilegios.”<sup>111</sup> Members of the unemployed associations responded to Kirchner’s call by protesting in front of Buenos Aires’ main cattle market at Linears and in front of the SRA’s central offices. An unemployed association leader declared: “Hoy nos movilizamos y venimos a denunciar a estos señores porque la Sociedad Rural y los militares se dedicaron a voltear presidentes en la Argentina y con esta denuncia le venimos a decir que pueblo y Gobierno no se lo vamos a permitir.”<sup>112</sup> Throughout his term, Kirchner deployed the loyal unemployed associations against his political adversaries, including rival PJ leader Duhalde, as well as other economic interests such as the oil companies (Etchemendy and Garay 2008: 7, Garay forthcoming).

### **Exporters’ Temporary Structural Power Constrains Export Tax Policy in 2002**

In contrast to the producers, the agro-export firms usually were not a relevant actor in export tax politics. Unlike the VAT rate on grains, the export taxes essentially did not affect the exporters, because they simply passed on the cost to producers through the prices they offered for grains.

In 2002, however, the Duhalde administration attempted to change the export tax rules in a way that the exporters deemed unacceptable. In contrast to the producers, who failed to win concessions because of their weak structural and instrumental power, the exporters were able to reverse this policy change thanks to their enhanced structural power—as explained in the Section I, grain exports accounted for the majority of the foreign exchange entering the country during the height of the economic crisis, which the government needed to reestablish macroeconomic stability.

In April 2002, rumors circulated that the government planned to increase export tax rates from 10% to 20%. The grain exporters advanced their operations on paper, listing large volumes of sales in the state-controlled export registry so that they would not be affected by the higher tax rates, even though the actual transactions would take place after the rate increases were implemented.<sup>113</sup> The increased volume of export operations registered in anticipation of the tax increase entailed an estimated revenue loss of 300 million dollars for the state.<sup>114</sup> To rectify the problem, the government subsequently announced that the export tax increase would apply retroactively to operations registered during the previous month. The exporters, however, viewed this initiative as an unacceptable change in the rules of the game that disrupted their normal operations. In response, they halted their economic activities, suspending shipments, purchases, payments to producers, and, most importantly, sale of foreign exchange.<sup>115</sup> These actions constituted a realized withholding threat involving multiple aspects of production. News

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<sup>111</sup>*La Nación*, March 22, 2006.

<sup>112</sup>*Ibid.*

<sup>113</sup>*La Nación*, April 19, 2002, April 23, 2002.

<sup>114</sup>*Clarín*, April 18, 2002.

<sup>115</sup>*La Nación*, April 18, 2002: “Crisis en la agroindustria: conmoción por una decisión oficial.” The press reported rumors that several international export firms even were considering withdrawing from Argentina (*La Nación*, April 18, 2002, *Clarín*, April 18, 2002: “Pelea y luego marcha atrás del Gobierno con los exportadores”).

coverage<sup>116</sup> and interviews (Exporters B, C 2008) suggest that withholding was largely market-coordinated; the decree created sufficient uncertainty and problems for setting purchasing prices that halting production was rational at the firm level. This demonstration of structural power motivated the government to reverse the reform. After three days of inactivity in grains markets, the government retracted the decree that had made the tax increases retroactive.<sup>117</sup>

After the 2002 incident, the exporters ceased to play a role in export tax politics. Subsequent rate increases were not applied retroactively and thus did not hurt the export companies. The government usually avoided problems of the sort that had arisen in 2002 by closing the export registry when credible rumors circulated that export tax changes were under consideration (Exporter B 2008, author's interview).

In addition, the exporters' structural power decreased after 2002 once the economic recovery was fully underway and the features of the new economic model stabilized. After the height of the crisis had passed, it no longer made economic sense for exporters to withhold investment or halt activities in order to influence tax policy, or even other issues with more direct impact on the sector, because agricultural exports were so profitable.<sup>118</sup> In combination with high commodity prices, an informant explained: "Argentina es un país donde es muy eficiente el canal de exportación. ...tenemos una estructura de exportación que es un cluster muy eficiente al nivel mundial, ... allí sobre el Rio Parana son todas las fabricas de molienda y puertas, ...te genera una ventaja competitiva insuperable," (Exporter C 2008, author's interview). For example, in 2003, when the Kirchner administration announced a reform to control tax evasion involving triangulation of grain exports through tax havens, the export firms complained stridently that the new regulations would destroy their ability to participate in futures markets, but once the reform became law, the exporters simply adapted to the new conditions (Chapter 5).

### **The 2008 Reform, Protest, and Enhanced Instrumental Power**

Export tax politics changed dramatically in March 2008 when Cristina Fernández de Kirchner's newly inaugurated administration increased the tax rate on soy from 35% to 44%. Given the producers' manifestly weak structural and instrumental power, government officials did not anticipate negative economic or political consequences in response to the 2008 reform; rather, they expected that production and investment would continue as they had after previous export tax increases. However, the reform catalyzed unity and protest among the four associations for the first time in recent history, thanks to the government's strategic errors in designing the tax increase and a context of accumulated producer grievances. The protests and the cohesion they stimulated ultimately led to the reversal of the tax increase. Facing heavy economic and political costs associated with the capital strikes, the Kirchner administration made multiple concessions that ultimately resulted in the repeal of the 2008 export tax increase.

#### ***The 2008 Export Tax Increase Provokes Mass Protest***

Two key factors explain why the 2008 reform provoked massive collective action despite otherwise weak cohesion. First, the novel design and impolitic presentation of the 2008 export tax increase incited unusually intense rejection from the producers. Second, a context of accumulated grievances disposed the producers to react more strongly to the 2008 export tax increase than on previous occasions. In essence, the 2008 reform pushed the producers past a threshold of tolerance and aligned them in opposition to the government.

The 2008 reform not only increased the export tax rate on soy substantially, but also established that tax rates would automatically increase or decrease according to a set formula when international prices fluctuated. While the large magnitude of the immediate tax increase contributed to the producers' outrage, it was the design of the "mobile" tax rates that proved particularly inflammatory. Effective

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<sup>116</sup>*La Nación*, April 23, 2002: "Cinco días después: Se anuló el decreto que hizo retroactivas las retenciones."

<sup>117</sup>*Ibid.*

<sup>118</sup>By late 2008, exporters also feared that ceasing to purchase grains would incur retaliation from the government through application of the broadly-worded *Ley de Abastecimiento*. (Exporter B 2008, author's interview).

export tax rates would be calculated using a table of marginal tax rates corresponding to different international price levels. The table included an extremely high top marginal tax rate of 95% applicable when soy prices surpassed USD 600/ton (MECON 2008: Art. 4). Although the effective export tax rate would never reach 95%,<sup>119</sup> this extremely high top marginal rate acted as a red flag that outraged the producers. The sector denounced the reform as confiscatory: “Poner un precio máximo—si aumentaba cien dólares, el gobierno se queda con 95 dólares, y el productor con 5, fue eso lo que se atacó. Te sacaron la expectativa de que pueda subir tu producto,” (Ambrosetti 2008, author’s interview).<sup>120</sup> Strictly speaking, the reform did not cap producers’ prices; however, they would increase very slowly above the threshold. Producers further complained that the rate scheme did not take into account increasing input prices, which they asserted would erode profit margins. The reform therefore frustrated producers’ expectations of increasing future profits. Further, the timing of the reform, issued shortly before the harvest season, intensified the producers’ frustrations over unrealized potential profits in the context of high international prices. That export taxes would automatically decrease if international prices fell did little to quell the producers’ outrage, perhaps due to the context of sharp increases in soy prices and expectations that this trend would continue. The 95% top marginal tax rate constituted a strategic error on the part of the government; a more moderate rate structure might have helped to contain the conflict.

Meanwhile, the producers had accumulated grievances related to state market interventions over the previous several years that disposed them to react strongly against the export tax increase. These grievances included periodic closures of exports for wheat and beef and complicated domestic price control systems for milk and wheat. Producers had many complaints over the government’s management of the price controls and subsidy systems; subsidies were reportedly slow, inefficient, and unreliable (author’s interviews: Corti 2008, MacLoughlin 2008). The producers also blamed the government for failing to regulate the export companies, which they accused of exploitation through unfair purchasing operations as well as tax evasion. Further, export restrictions imposed by the government widened the gap between international prices and producer prices, generating rents appropriated by the export companies (Ciappa 2008). The exporters’ material gains in the face of their own hardships outraged the producers: “Los exportadores han ganado fortunas. Estamos todos enojados con los exportadores. ... Han ganado fortunas. En ninguna parte del mundo ha ganado tanto plata Cargil y Dryfus...” (SRA A 2008, author’s interview). Moreover, the 2008 reform closely followed an export tax increase from 27.5% to 35% in November 2007, after the presidential elections that secured Fernández de Kirchner’s place as her husband’s successor. The 2008 reform confirmed producers’ fears that agricultural producers would fare no better during her term than under the previous administration. In addition, although soy remained highly profitable for most producers despite the reform, small producers on marginal land or in regions remote from ports were hard hit by the tax increase (Ciappa 2008, Corti 2008, author’s interview).

The 2008 rate increase therefore became “la gota que rebalsó el vaso” in the words of the president of the CRA,<sup>121</sup> or “el tope que puso a todo el sector agropecuario en un solo grito” according to an SRA (A 2008) informant. An FAA informant expressed a similar assessment:

El aumento de retenciones en si mismo era un problema, pero además actuó como detonante de un malestar que ya existía en todo el sector, producto de muy malas políticas en materia de ganadería, de lechería, de distintas producciones regionales, un muy mal funcionamiento de los mercados de granos... De manera que un conjunto de razones motivaron el conflicto este de cuatro meses. Pero claramente el detonante era el aumento de retenciones. (Corti 2008, author’s interview)

The day after the March export tax increase was announced, the four producers’ associations called for a joint strike, the first episode of coordinated protest in two decades. This historic event represented the first time that the SRA had endorsed a strike since Alfonsín’s presidency in the 1980s. The fact that producers in the countryside had so many grievances and were so enraged by the reform meant that a

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<sup>119</sup>For example, if soy reached an astronomical price of USD 800/ton, the effective export tax rate would be 61%.

<sup>120</sup>Other informants expressed similar sentiments (author’s interviews: Corti 2008, Watson 2008).

<sup>121</sup>*La Nación*, March 16, 2008.

coordinated strike would be easier to initiate and sustain, and concerns regarding adherence to and effectiveness of a strike were less salient. In fact, the response from the bases was overwhelming: “Fue absolutamente espontáneo y simultáneo. Todo el mundo reaccionó ante el mismo ataque de nuestros derechos,” (Watson 2008, author’s interview). The strikes were fueled and sustained by enthusiasm from producers on the ground infuriated by the export tax increase, many of whom did not belong to any of the four main agricultural associations (author’s interviews: Corti 2008, Watson 2008). As another informant remarked, the producers united in protest “por el horror de la medida,” (Ambrosetti 2008, author’s interview).

### ***Protest Through Capital Strikes***

The producers’ strikes involved a variety of protest actions, including demonstrations, rallies, and roadblocks, which were facilitated by the fact that the sector included large numbers of small and medium producers as well as large producers. Participation in some mobilizations reached estimates of 200,000 to 300,000 individuals.<sup>122</sup> However, capital strikes were the defining feature of the conflict.

The capital strikes entailed deliberate, coordinated decisions to halt delivery and sale of agricultural products to urban centers and agroexporters and to withhold investment in an effort to force the government to revoke the export tax increase. Withholding of these aspects of production was not coordinated by market signals, given that soy production and commercialization remained profitable for most producers despite the tax increase. Instead, collective action was necessary for sustaining these measures. As with all capital strikes, the participants incurred non-trivial short-term costs. Although non-perishables including soy and other grains were simply stored for sale at a later date, individual producers paid a significant opportunity cost by passing up the very high prices that prevailed during the three months of the strikes (Watson 2008, author’s interview).

### ***Increased Cohesion***

The 2008 reform and the protest it provoked greatly increased the producers’ cohesion by motivating the four associations to take a historic step toward organizational integration. Early in the conflict, the producers’ associations created an Enlace Committee to facilitate joint decision-making. The move toward organizational unification was as much a demand from producers on the ground as a strategic decision made by association leaders (author’s interviews: Watson 2008, Corti 2008, Zavalía 2008). Large numbers of unaffiliated producers participated actively in the strike and pressured the four associations to maintain a common front in defense of the producers (Corti 2008, author’s interview).

The Enlace Committee helped the producers associations achieve a level of coordination following the March resolution that differed qualitatively from the occasional, informal collaboration that had existed in previous years (SRA A 2008, author’s interview). Although technical staff from the SRA, CONINAGRO and CRA had regularly interacted on policy analysis and in negotiations with government technical teams, the four associations had maintained strict independence. Moreover, the FAA had not worked much with the other organizations given conflicts of interest with the larger producers (author’s interviews: SRA A 2008, CONINAGRO 2006). The strong personal relationships that developed among the leaders of the four associations as the conflict progressed (SRA A 2008: author’s interview) reinforced cohesion.

### ***Reversal of the 2008 Reform: Mechanisms of Influence***

Protest and enhanced cohesion ultimately led to a reversal of the 2008 export tax increase. The producers’ strikes forced the Kirchner administration to the negotiating table by inflicted heavy economic costs. Enhanced cohesion thanks to organizational integration facilitated continued protest. Further, cohesion strengthened the producers’ bargaining position with respect to the executive branch, enhanced

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<sup>122</sup>*La Nación*, July 16, 2008: “Contundente acto del agro en Palermo,” *Clarín*, May 26, 2008: “Masiva demostración de fuerza del campo,” by Matías Longoni.

the legitimacy of their demands, and improved their lobbying capacity in Congress, the venue in which the fate of the tax increase was ultimately decided.

At the outset of the conflict, the government was not disposed to negotiate. The administration dismissed producers' claims that the reform made production unprofitable and would provoke reduced investment; arguments based on structural power still lacked credibility. The new export tax rate set producer prices back to their values at the end of the previous year; the Secretary of Economic Policy asserted: "if it was profitable to produce soy two months ago, it will hardly stop being profitable now. Soy [prices] increased 70% in six months..."<sup>123</sup> Therefore, given the producers' track record of coordination problems, the executive likely anticipated that the strikes would be short-lived.

However, the sustained strikes eventually forced the government to grant concessions. The toll of the strikes was heavy, not only in terms of reduced economic activity, but also in terms of the impact on citizens' daily lives throughout the country. By the end of March, food supplies in Buenos Aires and other cities had substantially decreased, provoking price increases and shortages of perishable staples such as beef, chicken, and milk.<sup>124</sup> Cost estimates reached 300 million pesos per day.<sup>125</sup> Under these conditions, demonstrations by middle and upper-middle class sectors opposed to the government's policies and its management of the conflict erupted intermittently in Buenos Aires. Therefore, the government could not afford to leave the conflict unaddressed, not only from an economic perspective, but also from a political perspective. The producers' Enlace Committee coordinated and directed the strikes to enhance their bargaining position, calling for the actions to halt while negotiations were underway and calling for them to resume as needed to heighten pressure on the government.

Greater coordination among the four producers associations and a common purpose among their bases allowed them to sustain a united front throughout the conflict. Whereas the previous government had divided and conquered opposition from the agricultural sector, this strategy failed in 2008. At the end of March, for example, the four associations in unison rejected the government's offer of subsidies for small producers to compensate them for the export tax increase;<sup>126</sup> the government's efforts failed to split the FAA from the associations representing larger producers. Instead, the Enlace Committee demanded lower export tax rates for smaller producers, the FAA's preferred alternative. Enhanced dialog through the Enlace Committee had allowed the four associations to reach a compromise on the issue of differentiated tax rates, a proposal that the SRA previously opposed (Zavalía 2008, author's interview).<sup>127</sup>

The fact that the 2008 export tax increase had pushed producers past the threshold of tolerance also undermined government attempts to divide and conquer. The government's offers were unattractive given small producers' accumulated frustrations with previous compensations that had proved far less satisfactory in practice than anticipated (Corti 2008, author's interview). The government had simply lost credibility (Ambrosetti 2008, author's interview). In this context, small producers' incentives to defect from the united opposition front were weaker.

The producers' newfound cohesion also undermined another long-time government strategy for managing opposition: vertical equity appeals that served to delegitimize the producers' demands. The previous administration regularly portrayed the export taxes as a progressive policy tool that redistributed

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<sup>123</sup>*La Nación*, March 13, 2008: "Para el Gobierno, el campo sigue ganando."

<sup>124</sup>*La Nación*, April 1, 2008.

<sup>125</sup>Multimedia.com.ar March 29, 2008.

<sup>126</sup>*La Nación*, March 29, 2008. A number of other measures designed to placate small producers were announced as well, including the creation of a sub-secretariat to address the needs of small producers (*La Nación*, March 25, 2008).

<sup>127</sup>The SRA compromised on other issues to accommodate the FAA as well. For example, the SRA agreed to discuss the issue of regulating land rental markets and *pools de siembra*, another major concern of the FAA. The FAA saw the expansion of *pools de siembra* as a threat to small producers. These large-scale operations raised capital from investors beyond the traditional agricultural sector and rented land throughout the country to grow soy. Because their operations were so profitable, they could offer to pay very high rent for land, which had the effect of displacing traditional production systems. Although the SRA preferred to let free markets operate in the countryside and viewed the *pools* as a positive development in that they brought substantial investment into the countryside and created jobs, the association agreed to discuss the possibility of limiting the amount of land that a given pool could rent in the Enlace Committee as a concession to the FAA, whose participation in the alliance was critical (author's interviews: SRA A 2008, Corti 2008).

wealth from agrarian elites to the urban poor; Fernández de Kirchner intensified this rhetoric. For example, in her first speech to directly address the issue of the strike, she declared:

Recuerdo esa Argentina de los años 2003, 2002, 2001, miles de argentinos en piquetes, cortando calles, rutas porque les faltaba trabajo, porque hacía años que habían perdido su trabajo o, tal vez, en el 2001, porque se habían apropiado de los depósitos de pequeños ahorristas de la clase media. Eran los piquetes, como digo yo, de la miseria y la tragedia de los argentinos. Este último fin de semana largo nos tocó ver la contracara, lo que yo denomino los piquetes de la abundancia, los piquetes de los sectores de mayor rentabilidad.<sup>128</sup>

The President also explicitly identified the export taxes as a redistributive policy: “queremos volver a un país más justo, con mayor equidad, con mayor distribución. Porque las retenciones, no son medidas fiscales, son profundas medidas redistributivas del ingreso.”<sup>129</sup> However, the FAA’s participation in the united opposition front allowed the producers to counter the administrations’ assertions that the strikes responded to the interests of the agrarian elite. As a CRA informant candidly observed:

Si [el gobierno] enfrentaba un sector representante únicamente de la derecha, iba a ser muy fácil para el gobierno descalificarlo. Habiéndose unido las entidades, la de la punta de la derecha [SRA] y la de la punta de la izquierda [FAA], no había forma de pegarle ni de la derecha ni de la izquierda. Entonces era muy complicado [para el gobierno]. Creo que es gran parte del motivo del éxito. (Watson 2008, author’s interview)

Cross-class cohesion also allowed the producers to reframe the struggle as a battle between the provinces and the central government, rather than a battle between rich and poor.<sup>130</sup> Framing the conflict in these terms resonated with the provinces’ historical resistance to centralization. It also capitalized on growing discontent among many governors regarding their dependence on the executive’s discretionary allocation of export tax revenue to provinces, rather than automatic revenue-sharing, as was the rule with other taxes.<sup>131</sup> The following commentary from an SRA informant illustrates this reframing:

La plata de las retenciones va al gobierno nacional. La plata del impuesto a las ganancias va buena parte a las provincias. Lo que nosotros queremos es que nos liberen en parte las retenciones... y que paguemos de acuerdo a las ganancias que tenemos. ... Y lo que más me gusta de esto—que esa plata queda localmente en mi provincia. Si va todo al gobierno nacional, esa plata la dan con cuenta gotas, y a pedido, y ellos son los patrones, y ellos son los que manejan las cosas. Y eso es una porquería. (SRA A 2008: author’s interview).

As the strikes progressed, public opinion outside of Buenos Aires increasingly embraced the producers’ interpretation of the struggle.<sup>132</sup>

As the economic and political costs of the conflict grew, the government was forced to make more significant concessions that culminated in the remarkable decision to allow congress to decide the fate of the tax increase. While the government anticipated that congress would approve the proposal, thereby delegitimizing the producers’ resistance, this act constituted a major abdication of authority. Export tax policy in Argentina had long fallen under the purview of the executive branch. In addition, this move responded directly to the producers associations’ demands that all tax reforms should be legislated in

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<sup>128</sup>*Clarín*, March 26, 2008.

<sup>129</sup>Discurso de Cristina Fernández de Kirchner, 25 de Mayo 2008, Wikisource.org

<sup>130</sup>Similarly, support from lower groups, cultivated by economic elites, helped legitimate the autonomy movement in the Santa Cruz region of Bolivia and masked the elite’s underlying intentions of thwarting redistributive policies legislated by the central government (Eaton 2007).

<sup>131</sup>See for example: *La Nación*, March 21, 2008: “Impuestos y costos en alza,” by Jorge Oviedo, *La Nación*, March 23, 2008: “Polémica en el Congreso: la provincia que ya se gastó más de lo presupuestado para todo 2008;” *La Nación* March 30, 2008: “Recaudar no es sinónimo de redistribuir,” by Néstor Scibona, April 3, 2008: “Preocupa que avancen objeciones al reparto discrecional de las retenciones.”

<sup>132</sup>I thank Candelaria Garay for bringing these points to my attention.

Congress.<sup>133</sup> While the producers lacked strong relationships with legislators, they anticipated that lobbying in congress, where opposition to the executive's handling of the crisis was mounting, might nevertheless advance their interests.

Given the producers' increased instrumental power, the executive found it necessary to create much tighter links to social spending and other public goods in a bid to secure support from legislators. Whereas previous links to popular benefits had relied primarily on discourse alone, the proposal sent to Congress in 2008 formally earmarked revenue from the export tax increase. Article 3 created a "Social Redistribution Fund" to finance construction of public health care centers, housing, and rural roads; all revenue collected in 2008 and 2009 corresponding to the rate increase on soy and soy products would be destined to the fund.<sup>134</sup>

Notwithstanding the executive's efforts, the producers' sustained protests and coordinated lobbying ultimately contributed to a narrow rejection of the export tax increase in congress, which amounted to a stunning political defeat for the government.<sup>135</sup> On the one hand, explicit threats of renewed capital strikes<sup>136</sup> helped tip the vote against the government's proposal. According to producer association informants, legislators recognized that approving the executive proposal would merely prolong the debilitating crisis. In the words of one such informant: "los legisladores se dieron cuenta que no es un problema solamente del agro sino se iba a paralizar la economía del interior del país," (MacLoughlin 2008, author's interview).

On the other hand, the producers' enhanced lobbying capacity, thanks to stronger cohesion among the four associations, helped secure votes among the legislators. Whereas previous efforts had entailed only loosely coordinated lobbying by the producer associations' technical advisors, in 2008, the leaders of each of the associations visited legislators to explain the producers' cause, and lobbying was highly coordinated (SRA A 2008, author's interview). The producers also employed a new tactic: lobbying the governors, who exercised strong influence over legislators from their provinces.<sup>137</sup> Governors who sided with the producers faced probable retaliation from the Fernández de Kirchner administration in the form of reduced discretionary revenue transfers or other punishments,<sup>138</sup> however, the producers applied strong counter-pressure. Dissident PJ governors from Cordoba and San Luis, provinces with significant soy production, joined with the opposition against the tax increase.<sup>139</sup> The producers even pressured legislators to reject the bill by staging confrontational demonstrations in front of representatives' personal residences.<sup>140</sup> Producer association informants viewed these political actions as highly effective. As an SRA informant commented, many senators "se dieron cuenta que no podían volver a sus regiones porque los iban a matar" if they voted in favor of the executive initiative (SRA A 2008, author's interview).

Factors beyond the producers' protests and enhanced instrumental power also paved the way for the defeat of the export tax increase in congress. As mentioned previously, the producers were able to capitalize on governors' growing discontent over their dependence on the Kirchners' discretionary allocation of revenue to provinces. In addition, fissures had developed within the governing coalition due

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<sup>133</sup>In the "Proclama de Gualaguaychú" issued on April 2, 2008, the four associations proclaimed: "Queremos también que se echen las bases institucionales para los pasos futuros en el sagrado marco de la Ley y la Constitución, eso significa, para decirlo más claro, que sean los poderes legislativos los que establezcan los impuestos... En ese concepto se incluye además el control parlamentario, administrativo y judicial del destino de las imposiciones," (www.ruralarg.org.ar, accessed June 28, 2008).

<sup>134</sup>Proyecto 0013-PE-2008, June 16, 2008, www.diputados.gov.ar

<sup>135</sup>Kirchners' own Vice President, Radical Party politician Corbo, cast the deciding vote against the reform in the Senate.

<sup>136</sup>*La Nación*, June 4, 2008.

<sup>137</sup>See for example Eaton 2002: 135-141, Jones et al 2002, and Jones and Hwang 2005: 121-125.

<sup>138</sup>See for example *La Nación*, July 1, 2008: "El Gobierno promete premios y castigos según cómo se vote." "La idea de que la Casa Rosada puede influir en determinados gobiernos provinciales al punto de designar ministros o repartir cargos locales muestra la dependencia que algunas provincias tienen del poder central. A un gobernador, por ejemplo, le recordaron una promesa de obras inconclusas. 'Decíle a tus diputados que voten a favor si quieren que sigan las obras,' reveló un allegado a ese mandatario que pidió la reserva del nombre. Ese gobernador, de color oficialista, amagó hace unas semanas con distanciarse del Gobierno, pero su vocación rupturista duró poco." See also *La Nación* July 13, 2008, "El destino de las retenciones está en manos de 7 senadores."

<sup>139</sup>*La Nación*, June 25, 2008, July 20, 2008.

<sup>140</sup>*Página 12*, June 20, 2008, *Cronista*, July 17, 2008.



to power struggles as well as discontent over the executive's handling of the conflict.<sup>141</sup> Furthermore, the government committed multiple strategic errors, including the impolitic design of the 2008 tax increase and tardy efforts to fracture the producers' united front with selective compensations. In fact, former Finance Minister Miceli (2008, author's interview) believed the strikes never would have occurred had the government engaged the producers in dialog much earlier on.

However, the producers' protests and enhanced instrumental power were critical to the government's defeat. In retrospect, a producers association informant commented on the importance of both coordinated lobbying and capital strikes for winning the battle against the export tax increase:

Fue un trabajo muy duro, puerta a puerta, despacho a despacho, diputado a diputado. Estuvimos explicando en todas las comisiones, ... a todos los diputados los vimos, nos vimos a todos los senadores... Y aparte la presión social, de todo el interior, de todos los productores, creo que fue muy importante. Como se dejó de invertir con esta medida, todos en el interior vieron el impacto de la menor inversión, la caída económica. Entonces eso generó un rechazo social muy importante. ...Fue la sumatoria de todo. (Ambrosetti 2008, author's interview)

### ***Strengthened Instrumental Power Post-Conflict***

The producers' strikes appear to have left a legacy of strengthened instrumental power. First, the producers consolidated the Enlace Committee, the organizational backbone of cohesion.<sup>142</sup> The Enlace Committee continued to coordinate responses to government policy initiatives through 2009. Although divisions remain among the four producers associations, they have maintained a common front on issues such as price controls and export restrictions,<sup>143</sup> as well as export taxes. Moreover, the four producers associations established a financing mechanism to support the Enlace Committee's activities, in anticipation of continued strife with the government over agricultural policy. In August 2009, the associations announced the formation of a trust fund to be built from voluntary contributions of 0.2% of producers' grains sales.<sup>144</sup>

Second, the producers paid increased attention to the legislative arena and relationships with political parties. By the end of 2008, the producers were considering the possibility of proposing candidates for congressional elections in the coming year.<sup>145</sup> Opposition parties sought to cultivate the producers as a new constituency in the aftermath of the 2008 conflict. In June 2009, eleven former producers' association leaders and militants were elected to the national legislature on various opposition party tickets.<sup>146</sup> For the first time, the producers gained a measure of direct representation in congress. It is not clear whether or not these "*agrodiputados*" will respond to the Enlace Committee or to the parties on whose tickets they are registered,<sup>147</sup> but the election of these producers nevertheless represents a major turning point and forms the basis for enhanced instrumental power in the legislative arena.

Consolidation of the Enlace Committee and greater attention to relationships with political parties were motivated in part by continued frustrations in dealing with the executive branch.<sup>148</sup> The government did not grant the producers greater participation in policymaking after the battle over the 2008 export tax

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<sup>141</sup>These fissures may also have reflected growing discontent within these sectors regarding their marginal power within the governing coalition, as well as competing provincial interests.

<sup>142</sup>*La Nación* July 17, 2009: "Triunfo político, pero no económico."

<sup>143</sup>*La Nación*, July 21, 2009: "El campo se reunió con la Iglesia y busca más apoyo legislativo," *La Nación*, July 22, 2009: "Avanzaron la oposición y el campo en un proyecto común."

<sup>144</sup>Producers would voluntarily contribute 0.2% of their grains sales to a fund run jointly by the four associations. *La Nación*, Aug. 18, 2009: "El ruralismo tendrá US\$ 20 millones para financiarse." (The revenue estimates were later downgraded to USD 5 million.)

<sup>145</sup>*La Nación*, Dec. 24, 2009: "El agro se prepara para volver a la protesta en enero," *La Nación*, Jan. 5, 2009: "Vuelven hoy las protestas del campo."

<sup>146</sup>*La Nación*, June 28, 2009: "El agro ya cuenta sus propios diputados," *La Nación*, June 29, 2009: "El Agro logró once legisladores nacionales y cientos de ediles," *La Nación*, July 29, 2009: "Presentación de los agrodiputados".

<sup>147</sup>*La Nación*, July 25, 2009: "Los diez dilemas de la Comisión de Enlace."

<sup>148</sup>*La Nación*, Aug. 18, 2009: "El ruralismo tendrá US\$ 20 millones para financiarse."

increase, aside from sporadic invitations to dialog.<sup>149</sup> The Kirchner administration did present various measures intended to increase agricultural production, including lowering export tax rates on wheat and corn, but these initiatives did not satisfy the producers; they demanded much more radical reductions in tax rates on all grains including soy and an end to state intervention in commodity markets. The Enlace Committee in fact declared that the producers had secured no further economic benefits following the demise of the export tax increase.<sup>150</sup> This case confirms the importance of conflict with government for motivating business to invest in encompassing organization (Schneider 2004).

Recognition of the limitations of collective action outside of formal policymaking venues also contributed to the producers' interest in securing representation in congress. Strikes were no longer a feasible means of exerting influence after 2008, given both the costs to the participants and the likelihood of incurring negative public opinion.<sup>151</sup> Producer association leaders appeared reluctant to mobilize protests in the aftermath of the export tax battle,<sup>152</sup> although a number of relatively small-scale mobilizations did take place.

## Overview

Prior to 2008, the producers were unable to influence export tax policy due to weak structural power as well as weak instrumental power. Policymakers correctly anticipated that investment and production would continue despite export tax increases, given the tremendous profitability of soy. Meanwhile, fragmentation and lack of favorable relationships with policymakers in either the executive branch or the legislature made the producers very weak political actors. However, the impolitic design and large magnitude of the 2008 export tax increase incited large-scale protest despite previously weak cohesion by pushing producers' grievances past the threshold of tolerance. The producers were able to stage sustained collective action in the societal and economic arenas through mass demonstrations and capital strikes. In addition, their instrumental power in formal policymaking arenas increased due to enhanced cohesion based on organizational integration. Protest and increased instrumental power ultimately secured the reversal of the 2008 export tax increase; the producers achieved influence in this policy area for the first time in seven years. Ironically, however, the export tax rate on soy at the end of the conflict was higher than would have been the case had the 2008 reform remained on the books. With the demise of the reform, the rate reverted to 35%, whereas due to decreasing international prices, the rate would have declined to around 30% in the fall of 2008 according to the formula established in the March decree.

This case provides a contemporary confirmation of Schneider's (2004: 11) observation that "when it organizes, the private sector is essentially a reactor to government actions." Continued strife with the executive branch prompted the producers to consolidate their peak association and to invest in developing another source of instrumental power: relationships with legislators. Whether the producers continue to strengthen their new sources of instrumental power may again depend on how the government reacts to this new political actor.

## Comparison to Copper Taxation in Chile

Both Chilean and Argentine governments sought to increase taxation of highly profitable export sectors: copper in Chile, and soy and other agricultural products in Argentina. The technical logic of the taxes applied in the two cases was quite different: the tax on mining in Chile was a fee for extraction of a

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<sup>149</sup>*La Nación*, Dec. 22, 2008: "Para el campo, el anuncio es "a destiempo e insuficiente;" *La Nación*, July 17, 2009: "Triunfo político, pero no económico;" *La Nación*, July 25, 2009: "Los diez dilemas de la Comisión de Enlace."

<sup>150</sup> *La Nación*, July 17, 2009: "Triunfo político, pero no económico."

<sup>151</sup> *La Nación*, July 25, 2009: "Los diez dilemas de la Comisión de Enlace."

<sup>152</sup>In December, the leader of the FAA, previously a strong advocate of mobilization, announced that he would attempt to restrain the bases from blocking roads in response to discontent with agricultural policies. *La Nación*, Dec. 27, 2008: "De Angeli promete pelear para que no haya cortes de ruta." A subsequent article reported: "Ante la necesidad de conservar la simpatía pública lograda durante el extenso conflicto por las retenciones móviles, es improbable -pero nunca del todo descartado- que los productores vuelvan a cortar las rutas," (*La Nación*, Jan. 5, 2009: "Vuelven hoy las protestas del campo").

non-renewable resource belonging to the state, whereas the export taxes in Argentina were a key component of a broader economic development model. Yet both the mining tax and the export taxes served to raise revenue from previously under-taxed sectors profiting from increasing international commodity prices. Argentine governments taxed agriculture heavily with export taxes, raising tax rates when international prices increased (until problems arose in 2008). In Chile in contrast, the Lagos administration legislated a very moderate tax on copper extraction. The rate of the new tax was frozen in invariability clauses and could not easily be increased in subsequent years when copper prices skyrocketed, producing windfall profits.

Structural power cannot explain the different outcomes. Both the privately owned Chilean copper mines and the Argentine producers had weak structural power. Copper companies had invested in sunken assets and thus had low mobility, and while in theory higher taxation could have deterred future investment, Chile offered comparative advantages for copper extraction that probably would have offset the costs of a more substantial royalty. And in the case of the Argentine producers, soy production remained so profitable relative to other crops and/or investment options that the export taxes did not create market incentives for the producers to alter their behavior.

Instead, the Chilean copper sector's much stronger instrumental power compared to the Argentine producers explains why taxation of the latter was much heavier. The Argentine producers lacked any source of instrumental power, relationship- or resource-based, until the ill-designed 2008 increase provoked protest and organizational integration. In contrast, the Chilean copper sector benefited from three sources of power enjoyed by the business sector more broadly: partisan linkages, cohesion, and institutionalized government-business consultation. In particular, right parties in congress defended the copper sector's interests, and the economy-wide business association expressed solidarity with the sector. Institutional protections in the form of tax invariability clauses and supermajority requirements augmented the copper sector's instrumental power, whereas the executive's constitutional prerogative on export taxes in Argentina further undermined the producers' prospects for influencing policy by reducing the number of policymaking arenas in which the producers could seek to voice their interests.

However, the emphasis on sources of power highlights the fact that differences in the policymaking arenas in which these taxes were legislated on their own provide at best a partial explanation of the outcomes. One might suppose that export taxes in Argentina were heavier and more frequently increased than copper taxes in Chile simply because export taxes could be legislated by executive decree, whereas copper taxes required debate in congress. Exclusive executive authority in Argentina certainly facilitated export tax increases, yet it is crucial that the producers lacked relationship-based sources of power with respect to the executive branch. Further, had export taxes required congressional approval, outcomes may have been quite similar, given the producers' lack of instrumental power in the congressional arena as well.

### **Conclusion**

Sectoral tax policy in Argentina in the 1990s and 2000s included both successes and failures that are not only important within the Argentine context, but also remarkable in a broader comparative context. Major accomplishments were achieved in tax policy areas that affected both the financial sector and the agricultural sector. Limited access to bank information in the 1990s hindered the tax agency's ability to effectively control income taxes, which was problematic from the point of view of both revenue capacity and equity. However, the tax agency obtained full and automatic access to all relevant forms of bank information after 2001. Consequently, Argentina's tax agency is now among the most powerful in the world in terms of information access, significantly surpassing the Chilean tax agency, the historic example of efficiency in Latin America, and many tax agencies in the developed world as well.

Likewise, VAT evasion in the countryside was a problem of extraordinary dimensions in the 1990s, thanks to the fact that products destined primarily for export were included in the tax base. Because of the obligation to reimburse exporters' VAT payments, the state lost revenue that it had actually collected thanks to evasion within the agricultural sector. As of 2008, however, informants from all groups involved—the tax agency, exporters, and producers—agreed that this problem had been

definitively resolved (author's interviews: AFIP A, C 2006, Abad 2008, Exporter A, B 2006, Corti 2008). The tax agency now maintains excellent control of the VAT on agricultural products, an advance greatly facilitated by reducing the tax rate on grains, along with improving withholding regimes and other administrative advances. The former tax agency director observed that these reforms made a significant contribution to reducing overall VAT evasion from 35% in 2002 to 20% in 2007 (AFIP 2008: 6, Abad 2008, author's interview), a level comparable to Chile (around 14% in 2005) (Jorratt 2005, author's interview).<sup>153</sup> Improvements in controlling the VAT in the agricultural sector also freed the tax agency to focus on reducing income tax evasion in that sector (AFIP C 2006, author's interview).

Furthermore, after 2002, export taxes extracted major amounts of revenue from agriculture, a sector with historically high levels of domestic tax evasion. Export tax revenue helped to sustain the fiscal surplus, which was critical for restoring and maintaining macroeconomic stability and Kirchner's economic model more broadly, which proved highly successful in terms of growth and poverty reduction, at least through 2005.<sup>154</sup> Critics asserted that export taxes reinforced authoritarian tendencies in the executive branch by enhancing the president's ability to control provincial leaders through discretionary transfers;<sup>155</sup> critics also charged that export tax revenue discouraged the government from developing internal tax capacity. However, by increasing the central government's share of tax revenue relative to the provinces, the export taxes contributed significantly to fiscal discipline; the provinces' ability to secure highly favorable revenue-sharing rules for domestic taxes in the 1990s had been a recurrent problem for governments attempting to maintain balanced accounts (Eaton 2002, 2005). And while export tax revenue may have contributed to keeping some advisable tax reforms off of the government's agenda, it is important to note that this politically and administratively "easy" revenue source did not discourage strengthening of the tax agency or attention to more effective collection of domestic taxes, as evidenced by anti-evasion reforms discussed in Chapter 5 as well as expanded tax agency access to bank information.

Failures occurred in tax policy areas relevant to each of the sectors discussed in this chapter. Among the most noteworthy is Argentina's inability to tax interest earnings. The unusual individual income tax exemption for interest disproportionately benefits upper-income individuals and provides a loophole used by corporations to engage in tax avoidance. The income tax exemption for interest earnings harmed both revenue capacity and tax equity during the 1990s. It remains a source of inequity in the tax system today, although the tax expenditure associated with the exemption decreased after the 2001 crisis. In the realm of agricultural tax policy, the second Kirchner administration failed spectacularly in its attempt to increase export taxes in 2008, causing a loss of significant potential revenue given the surge in international prices for soy and other agricultural commodities.

I have argued in this chapter that variation in different sectors' instrumental and structural power across time and across policy areas explains Argentina's sectoral tax policy failures as well as the timing of its successes (Figure 6.2.9). Whereas business in Argentina achieved little influence over cross-sectoral taxes due to weak instrumental power and lack of structural power, certain sectors enjoyed one or both forms of power during delimited time-periods that allowed them to block or significantly modify tax reforms of sector-specific concern.

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<sup>153</sup>In fact, the Argentine tax agency now provides valued technical assistance on VAT control to tax agencies in Europe as well as Latin America (AFIP A 2006, author's interview).

<sup>154</sup>On expansion of social protections during this period, see Garay (forthcoming).

<sup>155</sup>See for example Levitsky and Murillo (2008).

**Figure 6.2.9: Business Power and Sector-Specific Tax Reforms**

	Financial Sector			Agricultural Sector	
	Taxing Interest Earnings	Expanding Bank Information Access	Taxing Financial Transactions	Reducing VAT on Grains	Taxing Exports
<b>Structural Power</b>	Strong	Strong, 1990s-2001	Weak	Weak	Weak
<b>Instrumental Power</b>	Strong, 1990s-2001	Strong, 1990s-2001	Strong, 1990s-2001	Moderate, 1998	Strong, 2008
<b>Reform Outcome</b>	Off Agenda	Off Agenda, 1990s-2001 Implemented, 2006	Implemented, 2001 Maintained, 2002-2008	Failed, 1998 Implemented, 2002	Implemented, 2002 Increases, 2003-2007, Failed, 2008

### Variation in Instrumental Power

In contrast to Chile, where business power was strong, stable, and homogeneous, the sources and the strength of business's instrumental power in Argentina varied substantially both across sectors and over time. Sources of instrumental power during the 1990s included recruitment into government and informal ties to executive-branch authorities in the case of the financial sector, and informal ties to the Secretary of Agriculture in the case of producers. The financial sector enjoyed stronger instrumental power thanks to more pervasive connections to executive branch officials, whereas the producers enjoyed informal ties to a single line minister with less authority over tax policy. These two sectors' instrumental power helped to block tax agency access to bank information, taxation of interest earnings, and reduction of the VAT rate on grains during the 1990s.

Both the financial sector and the producers lost instrumental power after 2001, in part because of the economic crisis and its aftermath, and in part due to turnover in the executive branch. The change of economic model provoked by the crisis decreased the financial sectors' economic importance and generated widespread public outrage against the banks; subsequent administrations did not include individuals with ties to the financial sector. The economic crisis reduced the producers' instrumental power in 2002 by weakening the Secretary of Agriculture's position within the executive branch relative to the Economy Minister, thereby rendering the producers' informal ties to their sectoral ministry a less effective source of power. As with the financial sector, presidents Kirchner and Fernández de Kirchner did not include individuals with close ties to the producers in their cabinets. Meanwhile, other sources of instrumental power remained absent. Neither sector enjoyed links to political parties in Congress. Meanwhile, lack of cohesion prevented the producers from engaging in effective collective action outside of formal policymaking arenas. In this context, post-crisis administrations were able to expand tax agency access to bank information, reduce the VAT rate on grains, and impose and increase export taxes on agricultural products.

However, the producers were able to mount sustained capital strikes in 2008 despite previously weak cohesion. The March 2008 export tax increase, which producers perceived as confiscatory, pushed accumulated grievances past the threshold of tolerance and catalyzed collective action. Steps toward organizational integration among the four producer associations increased their instrumental power by enhancing and institutionalizing cohesion, which in turn made collective action easier to sustain. Capital strikes, along with coordinated lobbying, contributed to the reversal of the export tax increase.

### Variation in Structural Power

Structural power also varied significantly, not only across sectors and over time, but also across policy areas affecting a single sector. In fact, the cases examined in this chapter illustrate that structural power is not a sector-level characteristic; structural power depends on the policy in question. Consider

the financial sector. Financial asset holders' strong structural power prevented tax agency access to fixed-time deposits during the 1990s, but structural power declined after 2001, facilitating reform. Financial asset holders' structural power also made eliminating the individual income tax exemption for interest earnings infeasible from the perspective of Argentine policymakers, not only during the 1990s, but also from 2002 through 2008. Structural power in both cases took the form of a credible exit threat: policymakers and the banking sector anticipated that these reforms would provoke negative aggregate economic outcomes resulting from market-coordinated individual investment decisions. The exit threat kept tax agency access to fixed-time deposits and taxing interest earnings off the agenda, even though policymakers viewed these reforms as otherwise appropriate and desirable. However, structural power was weak in another financial sector tax policy area: taxing bank transactions. Whereas the former two reforms affected highly mobile and volatile interest-earning accounts, the latter affected much less mobile and less sensitive checking accounts.

Turning to the agricultural sector, the producers' structural power remained weak with respect to VAT reduction and export taxes throughout the time-periods considered. Reforms in these policy areas simply did not create a credible threat of disinvestment. Policymakers anticipated no negative economic consequences to reform, and market-coordinated withholding in fact did not occur in the aftermath of these reforms. Overturning the 2008 export tax increase required a capital strike: politically-coordinated withholding. Because commercializing grains remained rational for producers from a profit-maximizing perspective, collective action was necessary to effect disruption of normal economic activities. The case of export taxes illustrates once again that mobility alone is not sufficient to create structural power; producers and investors easily could have shifted from soy to other crops in response to export tax increases, yet because soy production remained so profitable, tax increases did not create incentives for them to do so.

Economic crisis contributed to changes over time in structural power in both the agricultural and the financial sector, in some cases enhancing structural power and in other cases reducing it. On the one hand, the 2001 crisis increased financial asset holders' structural power with respect to interest taxation, by making depositors even more sensitive to the risks and opportunity costs of investing in interest-earning accounts. The crisis also temporarily enhanced the agro-exporters' structural power by increasing the state's reliance on these firms as a source of foreign exchange in 2002. On the other hand, the crisis weakened depositors' structural power with respect to bank information access, by reducing the share of funds in time deposits and the size of the banking sector itself, thereby reducing both the financial sector's and the economy's vulnerability to any additional disinvestment the reform might have provoked. The change of economic model precipitated by the crisis also reduced the producers' (already weak) structural power, but for very a different reason: agriculture received windfall profits associated with the currency devaluation, which made producers' complaints that increased taxation would deter investment entirely devoid of credibility.

International factors also contributed to variation in structural power over time in the policy area of tax agency access to bank information. In the context of increased concern regarding money laundering following the terrorist attacks in the US and a new international climate that legitimated tighter regulation of the financial system, investors were perceived to be less sensitive to tax agency oversight of their accounts, and the exit threat in this policy area accordingly declined. International pressures thereby had an indirect influence in this policy area; they did not directly drive the outcome.

### **Executive Strategies for Reform**

The policy areas examined in this chapter provide examples of both tax-side and benefit-side reform strategies, including obfuscating the incidence of tax increases, vertical equity appeals, compensation, linking to spending, and emphasizing stabilization. While business power was usually the primary factor shaping tax outcomes, these strategies often facilitated reform. Three cases merit special attention: obfuscating incidence in order to tax interest earnings in 1999, compensation plus emphasizing stabilization for taxing financial interest in 2001, and linking export tax revenue to social spending. In

addition, the 2008 export tax increases provides a noteworthy case in which government strategic failures undermined reform.

Obfuscating incidence was critical for taxing interest earnings in 1999 in a context of strong business power; however, this strategy entailed drawbacks that ultimately contributed to the reform's reversal. Constraints created by investors' structural power, as well as the banks' instrumental power, made imperative reducing the visibility of interest taxation by exploiting the phenomenon of burden-shifting. By taxing interest on the debtors' end of the flow rather than the creditor's end, and collecting payments from businesses rather than individuals, the Menem administration's tax on corporate debt avoided provoking the exit threat that continues to keep broadening the individual income tax base to include interest earnings off the agenda. However, drawbacks associated with obfuscating incidence contributed to the tax's limited duration. The reform not only made the tax burden less visible to individuals, but in practice it may also have shifted some of that burden to small corporations that were not in a position to pay higher taxes. This problem, along with the fact that the tax on corporate debt was difficult to understand, led to its reversal once a new administration took office. Eliminating the exemption for interest earnings in the individual income tax, had it been politically and economically feasible, may ultimately have proven a more legitimate and enduring reform (Guidotti 2006, author's interview).

The 2001 financial transactions tax serves as a second example in which executive reform strategies—compensation and emphasizing stabilization—facilitated a significant tax increase in a context of strong business power. The banks enjoyed strong instrumental power, but thanks in part to these strategies, they did not oppose the new tax. These strategies also precluded opposition from business more broadly. This case illustrates that emphasizing stabilization can be effective even where business is not cohesive at the cross-sectoral level, contrary to some arguments (Weyland 1997).

Linking tax increases to social spending in the policy area of export taxes in Argentina illustrates that tighter linking techniques become necessary for the success of this strategy as business power increases. From 2002 to 2007, links to social spending were primarily informal and rhetorical in nature, in contrast to the Chilean tradition of formally tying tax increases to social spending in the text of reform proposals. This difference reflects the greater ease of increasing taxes in Argentina due to weaker business power than in Chile.<sup>156</sup> After March of 2008, however, tighter links to spending became necessary given the producers' greatly increased instrumental power. The Fernández de Kirchner administration for the first time formally tied export tax revenue to social spending in a proposal sent to congress. This measure proved insufficient, however, given the advanced stage of the conflict.

The 2008 export tax increase also illustrates how strategic failures on the part of the government can undermine reform initiatives, even in a context of weak business power. The design of this reform, in particular the 95% top marginal rate, helped provoke the producers' strikes. Had the government chosen a less extreme top marginal rate or simply waited to impose additional tax increases until international prices increased further, instead of establishing a fixed table of "mobile" tax rates, the problems that ensued might have been avoided. In addition, more timely and more extensive compensations for small producers might have thwarted formation of a united opposition front and precluded mass protest.

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<sup>156</sup>In addition, given the importance of discretionary spending in Argentina as well as a history of economic instability, the executive probably had incentives not to earmark tax increases to specific programs.

## **Chapter 7. Second-Generation Tax Reform in Bolivia (2003-2006): Business Power vs. Popular Mobilization**

This chapter applies the business power framework to the issue of second-generation tax reform in a Latin American country with a much lower level of development: Bolivia. In this unusual case, business power was challenged by counter-mobilization on tax issues and an imminent, radical threat from below to the socio-economic and political status quo.

During the time-period when Bolivian policymakers considered second-generation tax reforms, 2003-2005, business enjoyed significant instrumental power at the aggregate level—weaker than in Chile, but much stronger than in Argentina. However, the strength of popular sector actors counterbalanced business power. During this period, Bolivia experienced phenomenal levels of popular mobilization; meanwhile, Evo Morales and his indigenous-left party, *Movimiento al Socialismo* (MAS), which had strong ties to popular sector organizations, achieved significant representation in congress, an arena long dominated by three elite-oriented, patronage-based parties. Popular sectors rejected tax increases perceived as regressive, compelling the executive to eliminate reforms that did not patently target elites from the set of feasible revenue-raising options. And in one case, popular sectors mobilized to demand higher taxation of economic elites. Business in Bolivia therefore could not keep reforms it opposed off the agenda, in contrast to Chile, where strong instrumental power in the absence of countermobilization afforded business a significant degree of control over the tax agenda. Further, mass mobilization to demand taxation of economic elites in Bolivia could overwhelm business power during subsequent stages in the policy process.

Three reform episodes illustrate the political dynamics associated with popular mobilization and business power: an income tax proposed in 2003, an assets tax and a financial transactions tax proposed in a 2004 reform package, and a hydrocarbons law reform legislated in 2005. The 2003 income tax proposal, inaccurately perceived as broad-based in incidence, was defeated by popular protest; the government's strategic errors contributed to this dramatic and unanticipated outcome. The 2004 assets tax proposal was designed to preclude popular protest by much more clearly targeting economic elites, but it instead provoked strong business opposition. In the absence of active popular sector support for the government's proposal, business's instrumental power ultimately led to the demise of the assets tax. In contrast, the financial transactions tax was successfully implemented. The transactions tax did not threaten elite interests as directly as the assets tax; the government's benefit-side strategy of emphasizing stabilization also contributed to business's eventual acceptance of the tax. The 2005 hydrocarbons reform, which dramatically increased taxation of that sector, was initiated despite business opposition in response to explicit demands from mobilized popular sectors. The threat of widespread protest verging on social revolution if popular demands were not met pressured congress to legislate a much harsher law than the draft proposal negotiated by the executive with the hydrocarbons companies. Business was thus unable to defend its interests despite substantial structural power in this policy area, as well as instrumental power.

### **Business's Instrumental Power**

From 2003 to 2004, business enjoyed significant instrumental power, thanks to cohesion and linkages to political parties based on recruitment and informal ties. However, instrumental power was of intermediate strength in comparative context. Business cohesion at the aggregate level in Bolivia was weaker than in Chile due to a regional cleavage, but much stronger than in Argentina. Linkages to parties were also weaker than in Chile during this period, due to the absence of a programmatic right party, but stronger than in Argentina.

### **Cohesion**

Organization and shared identity gave business in Bolivia significant capacity for collective action. First, Bolivia has a strong, prestigious economy-wide business association, the *Confederación de Empresarios Privados de Bolivia* (CEPB), founded in 1962. Its member organizations include regional



business federations and sectoral business associations. The CEPB has long been an important actor in national politics, both prior to and following the 1982 transition to democracy. The CEPB played a key role in pressing for a transition to democracy in the early 1980s, and then in mobilizing business opposition against the leftist Siles administration, including capital strikes in 1984 (Conaghan and Malloy 1994: 95-7, 121-24). The CEPB has been a key interlocutor between government and business since the democratic transition. As Eaton (2007: 88) observes: “In contrast to many other Latin American countries, the comprehensive nature of the CEPB and its overlapping sectoral and geographic organization have consistently given business a unified voice in the national government.” Business organization is also strong at the regional level. In Santa Cruz, the economic capital of Bolivia (which generated an average of 30% of the country’s GDP and 37% of total tax revenue from 2002 to 2004),<sup>1</sup> the *Cámara de Comercio y Industria* (CAINCO) and the *Federación de Empresarios Privados de Bolivia-Santa Cruz* (FEBP-SC) aggregate business interests across sectors. As Eaton (2007: 85) documents, the growing threat to property rights posed by MAS’s ascent in national politics encouraged Santa Cruz’s diverse business interests to close ranks behind the leadership of these regional peak associations (CAINCO in particular).

Second, organized business shares a strong common identity constructed in contraposition to the large informal sector. Organized business regularly emphasizes that the small formal sector it represents bears the full burden of taxation, whereas firms and entrepreneurs in the informal economy—70% of the private sector according to the CEPB’s estimates (Mustafa 2006, author’s interview)—do not pay. Informal sector businesses that cut costs by evading taxes create “unfair” competition for formal sector businesses. The “formal sector” identity<sup>2</sup> is also to a large extent an upper-class identity; the informal sector comprises primarily subsistence activities and small vendors. However, the divide between organized business and the informal sector does not coincide strictly with class; informants from the former group were quick to point out that the informal sector includes large entrepreneurs who should by all accounts bear a sizable tax burden. In fact, La Paz is home to a small but prosperous indigenous elite that has made fortunes by trading in contraband, particularly electronics (F. Cossio 2006, author’s interview). Further, it is a well-known fact that many medium-sized businesses “hide” in simplified tax regimes designed for small contributors in agriculture, transport, and commerce. A racial dimension reinforces the “formal sector” identity: the organized business sector is largely of Hispanic descent, whereas the informal sector is largely indigenous. As Eaton (2007: 89) observes: “a new Aymara economic elite has begun to emerge in cities such as El Alto and La Paz, but the ethnicity of these elites, combined with their orientation toward commercial rather than large-scale productive activities, tends to arouse the suspicion and derision of Santa Cruz business groups.” This ethnically-motivated derision is shared by leaders of organized business in La Paz. The president of the CEPB, for example, referred to President Morales (2006-present) as “*ese indio*” in an interview with the author. Organized business’s shared antagonism toward the informal sector translates into a dogmatic rejection of tax increases that is functionally equivalent to Chilean business’s ideological opposition to taxes based on free-market economic principles.<sup>3</sup> In the words of the former president of the CEPB:

Mientras que no se resuelve el problema de informalidad, estamos en desacuerdo con la creación de cualquier impuesto. Y esa fue con Banzer, con Quiroga, con Sánchez

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<sup>1</sup>INE ([www.ine.gov.bo](http://www.ine.gov.bo)), SIN ([www.impuestos.gov.bo](http://www.impuestos.gov.bo))

<sup>2</sup>Note that this identity does not objectively correspond to those who pay taxes as opposed to those who evade taxes. Many businesses that belong to the self-identified “formal sector” almost certainly engage in some degree of evasion as well.

<sup>3</sup>Although business in both Chile and Argentina also advocated fighting tax evasion rather than increasing the burden on those who already pay, a “formal sector” identity of the sort present in Bolivia was absent. In Chile, business class cohesion was strong due to other factors, and VAT evasion is relatively low. Evasion was historically much more pervasive in Argentina; VAT evasion rates were similar to Bolivia. However, there is no racial dimension to consolidate a distinct “formal sector” identity among business given the presence of so many other divisions that undermine cohesion.

de Lozada, con Mesa, y se va también con Morales. Primero ocúpense a resolver el problema de informalidad. (Mustafa 2006, author's interview).<sup>4</sup>

However, a regional division within the business community undermines business cohesion at the national level. This division emerged due to differences of opinion regarding strategies for defending business interests. While the La Paz-based CEPB displayed a greater predilection for dialog and compromise with the government in the aftermath of the popular protests that led to Sánchez de Lozada's resignation in October of 2003 and MAS's increasing voice in national politics, business in Santa Cruz and other lowland departments assumed a more intransigent position and charged that the CEPB had failed to adequately defend business interests<sup>5</sup> (Eaton 2007: 89). Business intransigence in Santa Cruz owed to the availability of an exit strategy that was not an option for elites in La Paz. Given Santa Cruz's economic viability as an independent unit and its geographic distance from La Paz, business and aligned political elites in Santa Cruz began to demand departmental autonomy of a sort that would shield them from the emerging redistributive threat at the level of national politics (Eaton 2007, Eaton forthcoming).<sup>6</sup> Business in Santa Cruz was distrustful of the Mesa administration (2003-05) given its exclusion from the cabinet as well as the president's willingness to negotiate his program of government with MAS (Eaton 2007). Power struggles within the CEPB as well as a perceived difference in the orientation of economic activities vis a vis the state also contributed to the regional division: "Santa Cruz business elites dismiss their counterparts in the west, who they believe prospered through the extraction of resources from the state rather than through productive activities," (Eaton 2007: 89).<sup>7</sup> Tensions within the business community culminated in the withdrawal of the Santa Cruz departmental federation, the FEPB-SC, from the CEPB in February 2004.<sup>8</sup>

Compared to Chile and Argentina, business cohesion in Bolivia can be scored as intermediate in strength. Because of the regional division, opposition to tax increases was less coordinated than in Chile. Governments in Bolivia faced two business blocks—one coordinated by the CEPB and the other by the Santa Cruz peak associations—that sometimes voiced different demands. In contrast, governments in Chile faced a single opposition block coordinated by the CPC. However, opposition to tax increases was more coordinated in Bolivia than in Argentina, where business organization was highly fragmented and a common business identity was absent. In Bolivia, tax proposals that targeted economic elites elicited two independent but internally cohesive opposition fronts: one led by the CEPB and one led by the Santa Cruz peak associations. In essence, cohesion in Bolivia was strong but bifurcated. In Argentina, in contrast, coordinated opposition rarely emerged.

### **Relationships with Parties**

From the late 1980s through 2005, Bolivia's traditional political parties, all of which were largely non-programmatic and heavily patronage-oriented (Gamarra and Malloy 1995), were connected to business through a mixture of partisan linkages, recruitment, and informal ties. I first discuss business relationships with the right party ADN and its successor, PODEMOS. I then discuss business's informal ties with the MNR and MIR, which together held the majority of seats in congress from 2002 to 2005, the primary period of interest for second-generation tax reform.

*Acción Democrática y Nacionalista* (ADN), founded by former dictator Hugo Banzer, can be considered a right party according to Gibson's definition; business and economic elites, particularly in Santa Cruz, formed the core constituency. The ADN's ranks included "notable businessmen who had

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<sup>4</sup>Similar statements were made by other business informants (author's interviews: ASOBAN B 2007, Barriga 2007, Dabdoub 2007, Kieffer 2007, Marinkovic 2007, Yovhio 2007). See also CAINCO 2003a and CAINCO 2004b: 18-20.

<sup>5</sup>*La Razón*, Feb. 27, 2004: "Empresarios eligen una nueva directiva y profundizan su crisis," *El Deber*, Feb. 28, 2004: "Pugnas y traiciones dividieron a empresarios,"

<sup>6</sup>CAINCO leaders even expressed an interest in Santa Cruz succeeding from the nation (Eaton 2007: 88).

<sup>7</sup>My business informants expressed this point as well, asserting that economic activity was state-oriented in La Paz but market-oriented in Santa Cruz (author's interviews: Ortiz 2007, Barriga 2007, Matkovic 2007, Saavedra 2007).

<sup>8</sup>*La Razón*, Feb. 27, 2004: "Empresarios eligen una nueva directiva y profundizan su crisis," *El Deber*, Feb. 28, 2004: "Pugnas y traiciones dividieron a empresarios."

served in Banzer cabinets” (Conaghan and Malloy 1994: 126, see also Gamarra and Malloy 1995: 417). Personalistic ties to Banzer held the party together, but “personalism was coupled with a push by Banzer to develop the party as the principal voice for the Bolivian right... The party also reinforced its sober image by signing an accord with the U.S. Republican party,” (Conaghan and Malloy 1994:126). Banzer himself had close relationships with economic elites in Santa Cruz, particularly in agriculture and industry (Eaton 2007: 77). During his rule from 1971 to 1978, he channeled cheap credit to Santa Cruz through the state agricultural bank, to the immense benefit of agro-business; much of the debt was never collected (Connaghan and Malloy 1994: 57-8, Eaton 2007: 79). Banzer’s policies during his subsequent presidential term (1997-2001) also favored economic elites in Santa Cruz; for example, he benefited the department’s large rural landowners by lowering property taxes. The ADN all but collapsed after Banzer’s death in 2002; ADN held only one senate seat and four out of 130 seats in the lower house from 2002-2005.

In 2005, PODEMOS (*Poder Democrática Social*), a new right party constructed on ADN’s remains that also absorbed politicians from MIR and MNR, won significant representation in congress, including almost half of the senate seats. Like ADN, PODEMOS enjoyed its strongest support in Bolivia’s five comparatively wealthy lowland departments, the so-called “*media luna*,” 8 of the party’s 13 senators elected in 2005 represented these departments. PODEMOS also maintained strong ties to business. Several business leaders were prominent PODEMOS politicians, including Senator Oscar Ortiz, a former general manager of CAINCO, and Deputy Oscar Franco, a former vice-president of the *Federación de Ganaderos de Santa Cruz*. PODEMOS forged increasingly strong links to economic elites in Santa Cruz and throughout the *media luna* in the struggle against President Morales and the redistributive threat he posed, as evidenced in PODEMOS’s support for the conservative autonomy movement led by the civic associations and business associations in Santa Cruz (Eaton forthcoming: 8). PODEMOS became the main political opposition to MAS at the national level from 2005-2009.

While the *Movimiento Nacionalista Revolucionario* (MNR) and the *Movimiento de Izquierda Revolucionaria* (MIR) cannot be considered right parties, they had each developed informal ties with business and had recruited businessmen into their ranks by the 1990s. The MNR originated in the 1950s as a populist, mass-based party promoting state-led development. However, President Paz Estenssoro (1985-1989), one of the party’s founders, abandoned his support for state-centered development in favor of neoliberal reforms following the transition to democracy. Like ADN, the MNR included prominent business people, most importantly, Sánchez de Lozada, the author the neoliberal adjustment plan implemented with business support under Paz Estenssoro in 1985. Sánchez de Lozada, known as one of the country’s wealthiest businessmen, had ties to the CEPB (Conaghan and Malloy 127, 129). The MIR, ostensibly a social-democratic party, also developed ties to business in the 1990s (Gamarra and Malloy 1995: 414). For example, MIR senator Vaca Diez, who served as the president of senate in 2004, was a self-described agricultural businessman from Santa Cruz.<sup>9</sup> Both the MNR and MIR had ties to Santa Cruz’s economic elites, especially those in agriculture (Eaton forthcoming: 16, Mesa 2006, author’s interview), although ADN had been most closely associated with that constituency. Political representation of the prosperous *media luna* departments was shared by the MNR and MIR in the aftermath of ADN’s collapse. Of the *media luna*’s 12 senators from 2002-2005, 7 belonged to the MNR, 4 to the MIR, and one to the all but defunct ADN.

As in Argentina, party leaders’ control over legislators’ career paths, thanks to party-oriented electoral rules (Eaton 2002), helped to attenuate business influence in congress, despite business’s linkages to the traditional parties. The president and legislators are elected through a closed list system in which citizens cast a single vote for their party preference, and party leaders determine who occupies the seats won. A reform in 1994 made half of the lower house elected via single member districts, but this system still left significant power in the hands of party leaders (Gamarra 1997, Mayorga 2005, Barr 2005). This system encouraged discipline in congress, particularly when the president of the nation was also the president of his party.

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<sup>9</sup>*La Razón*, March 6, 2004: “La presiones, temor y debilidad política hicieron cambiar a Mesa.”

However, maintaining control in congress and curtailing business influence also required the executive to distribute ample patronage among the governing coalition parties. Presidents from 1985 to 2005 all had to form pacts with at least one other party to secure a majority in the legislature. Awarding patronage posts in the government helped to secure coalition party discipline (Gamarra and Malloy 1995: 423-24). When the president's ability or inclination to distribute patronage declined, so did the president's ability to secure votes in congress, particularly when business opposed the legislation at hand.

Informal ties to parties did not serve as a particularly strong source of business power during President Sanchez De Lozada's short second term (2002-03), thanks to his ability to maintain control over the governing coalition. First, Sanchez de Lozada had secured authority over other factions within the party following Paz Estenssoro's retirement (Conaghan and Malloy: 416, Mayorga 2004: 38); internal elections in 2001 reinforced Sanchez de Lozada's status as the party's "*caudillo indiscutido*," although the MNR remained divided between the old political guard and the new more technocratic wing represented by the president (Mayorga 2004: 38). Second, distribution of patronage appointments between the MNR and the MIR helped to secure discipline within the governing coalition, although as Gamarra (2008: 128) notes, Sanchez de Lozada was throughout his term "accosted by politicians demanding patronage... the government was continuously forced into a pattern of expanding the size of the ruling coalition to prevent traditional party politicians from subverting Sanchez de Lozada." Passing legislation in congress was no easy task, and business lobbying was often intense, as in the case of a major tax code reform initiated in 2003. As a former Finance Ministry informant recalled:

All of the senators had these papers on their desks—opposition [senators], government senators, everyone. And these were the business organizations' reasons why not to approve the tax code. The *Empresarios Privados* [CEPB] and CAINCO. *Empresarios Privados de Bolivia*, with the seal and everything. ...the senators and the congressmen were using this as the guideline to oppose the law. (F. Cossio 2006, author's interview)

However, the government ultimately managed to contain most of the business pressure and impose discipline on the governing coalition; the Finance Ministry informant estimated that the final legislation contained 80% of the changes the government had sought to enact.

Business's informal ties to the parties became a much more effective source of instrumental power after Sanchez de Lozada resigned in October 2003 and was replaced by his Vice-President, Carlos Mesa. The new president lacked authority over the political parties. Mesa was an independent journalist with no political affiliation; in fact, Mesa was the first president since the transition to democracy who was not also a leader of a major political party. Accordingly, Mesa had no influence whatsoever over legislators' career paths. Further, Mesa appointed a new cabinet composed of independents, a move that further isolated him from the parties. By Mesa's own account (author's interview, 2006), his relationship with congress was very difficult. In this context, legislators with informal ties to business were free to be much more responsive to business interests. Business lobbying in congress, particularly with respect to the MNR and MIR, which together held 15 of 27 seats in the Senate, could be highly effective.

During Mesa's government (October 2003-June 2005), business's relationships with parties in Bolivia were not as strong as in Chile, where business enjoyed partisan linkages to programmatic right parties. ADN, Bolivia's right party, had all but vanished from congress and had not yet been replaced by PODEMOS; business relationships with the MNR and MIR were based largely on informal ties and recruitment, which tend to afford more contingent influence than partisan linkages. But business relationships with parties in Bolivia during this period were stronger than in Argentina, where executive control over legislators usually limited the effectiveness of business's informal ties.

### **Relationships with the Executive Branch**

Following the transition to democracy, governments often appointed businesspeople to cabinet positions. For example, as described above, Paz Estenssoro appointed wealthy businessman Sanchez de Lozada as his Finance Minister in 1985. And members of Santa Cruz's agricultural elite held cabinet positions under every administration through 2003 (Eaton 2007: 83, Mesa 2006, author's interview).

Informal ties and/or recruitment into government facilitated business access to policymakers but did not guarantee business influence over policy. For example, as president, Sanchez de Lozada designed tax policy according to technocratic criteria and his own long-term vision for the country, despite his business connections. In 2003, he reversed a property tax reform implemented during Banzer's presidency that had amounted to a give-away to Santa Cruz's landed elite (author's interviews: Comboni 2007, F. Cossio 2006, Justiniano 2007). During direct negotiations with Sanchez de Lozada and his technical team, the *Cámara Agropecuario del Oriente* (CAO) secured a number of concessions, including a slower phase-in of the tax increase, but the landowners were unable to stop the reform despite informal ties to members of the administration. The limitations to business influence in this case are consistent with the observation that instrumental power arising from informal ties and/or recruitment tends to be contingent on characteristics of the particular policymakers involved (Chapter 2).

Under Mesa (2004-2005) and Morales (2006-present), business did not enjoy recruitment into government or informal ties to the executive branch. Mesa appointed a cabinet of independents, excluding the Santa Cruz agricultural elite for the first time since the transition to democracy. Morales also excluded business from the executive branch, as expected given MAS's anti-neoliberal rhetoric and its core constituency among popular sectors and indigenous groups.

**Figure 7.1: Instrumental Power (Aggregate Level) in Comparative Context**

Source of Power	Chile, 1990-2009	Argentina, 1992-2008	Bolivia, 2002-03 (Sanchez de Lozada)	Bolivia, 2003-05 (Mesa)
<b>Cohesion</b>	<b>Strong</b> Economy-Wide Organization, Anti-Tax Ideology	<b>Weak</b> Cross-Sectoral Fragmentation, Less Ideological	<b>Strong</b> Economy-Wide Organization, Formal-Sector Identity (Regional division not activated)	<b>Intermediate</b> Bifurcated Cohesion: Economy-Wide Organization with a Regional Division, Formal-Sector Identity
<b>Relationships with Parties in Congress</b>	<b>Strong</b> Partisan Linkages	<b>Weak</b> Recruitment and Informal Ties: Ineffectual given strong executive control over legislators	<b>Weak-Intermediate</b> Recruitment and Informal Ties: Tempered by executive control over legislators	<b>Intermediate</b> Recruitment and Informal Ties: Un-tempered by executive control over legislators
<b>Relationships with Executive</b>	<b>Strong</b> Institutionalized Consultation	<b>Weak</b> Recruitment and Informal Ties: Relevant at sectoral level only	<b>Intermediate</b> Recruitment and Informal Ties: Tempered by Sanchez de Lozada's independent agenda	<b>Weak</b> Exclusion

### Business's Structural Power

Structural power was largely irrelevant with respect to the tax proposals considered in this chapter due to other priorities that preempted any existing concerns over investment outcomes. In 2003 and 2004, raising revenue was imperative for preserving fiscal stability given gaping budget deficits. Business's arguments that tax increases of any kind would contract economic activity were therefore of little import when Sanchez de Lozada proposed the individual income tax in 2003. Further, Sanchez de Lozada's former Finance Minister pointed out that the individual income tax was far less distortionary, more growth-friendly, and would have had a less direct affect on the business sector than other revenue-raising options available at that time, such as increasing taxes on fuel or Bolivia's cascading turnover tax<sup>10</sup>

<sup>10</sup>This tax is known as the *impuesto a las transacciones*, not to be confused with the financial transactions tax.

(Comboni 2007, author's interview). Dire fiscal need also superceded any concerns the Mesa administration may have harbored regarding the financial transactions tax, which might have created disincentives for using the banking system. Unlike Argentina's transactions tax, this proposed tax would affect deposits and withdrawals to and from not only checking accounts, but also more mobile savings accounts (as well as other financial transactions). Announcement of the transactions tax did in fact provoke a reduction in bank deposits of approximately USD 60 million in late January, although Mesa's Finance Minister expressed confidence that deposits would return.<sup>11</sup> The economic team feared an outcome far worse than a drop in bank deposits—spiraling inflation or even hyperinflation, a likely consequence of government borrowing from the Central Bank to cover budget obligations—if the proposed taxes were not approved (Cuevas 2007, author's interview). In these circumstances, the transactions tax had two highly desirable features: easy implementation and capacity to quickly raise significant amounts of revenue.

In the case of the 2005 hydrocarbons reform, concerns over popular mobilization preempted concerns over structural power. Executive policymakers did fear that much higher taxation of the hydrocarbons sector would cause foreign investment to decline, jeopardizing Bolivia's ability to develop and profit from its natural resources (author's interviews: Mesa 2006, Jemio 2006). However, moving forward with the reform was imperative for preserving social peace, a much more immediate priority.

### **Popular Sector Mobilization**

Widespread popular mobilization that posed an imminent threat to the prevailing social and political order is a critical feature of the Bolivian case that must be considered in addition to business power. From 2000 to 2006, Bolivia experienced what Barr (2005: 70) describes as a “virtually continuous cycle of protest” increasingly directed against the political system and the exclusionary socio-economic status quo more broadly. In a context of growing dissatisfaction with the traditional political parties and the neoliberal economic model, a wide range of sectors took to the streets to voice their demands. Organized coca-growers under the leadership of Evo Morales endeavored to end coca-eradication campaigns, Aymara leader Felipe Quispe sought to overturn white political and cultural domination, citizens opposed privatizations that they suspected would lead to higher consumer prices for basic services, and the central labor union (*Confederación Obrera Boliviana*, COB), in conjunction with police, teachers, and other sectors, demanded higher wages (Barr 2005, Arce and Rice 2009).

Protests mounted by these sectors, sometimes organized and sometimes uncoordinated, created major crises for the national government. Protests initiated by a particular sector with specific demands often sparked protest by other sectors, culminating in paralysis of urban centers, as occurred in the April 2000 “water wars” in Cochabamba and subsequent demonstrations (Mayorga 2005, Barr 2005, Arce and Rice 2009). In the words of Mayorga (2005: 174), the April 2000 protests “paralyzed the country's economy and besieged the government.” Similarly, *cocalero* strikes in September 2000, joined by informal sector workers, university students, and transport workers, paralyzed the department of Cochabamba and cut off transportation to urban centers for almost a month (Barr 2005: 72-3). Protestors engaged in a continuous escalation of tactics to draw attention to their demands. Road-blocks, a common Bolivian protest tactic, created far-reaching disruption, particularly after 2000 when traditional tactics of creating blockades with tree trunks and stones were supplanted by mass physical occupation of highways, making it more difficult for state authorities to restore normality (Arce and Rice 2009: 92).

Popular mobilization reached unprecedented levels in 2003, culminating in a “civil insurgency” (Lazarte 2005: 455) that toppled the national government. Demonstrations in La Paz in February 2003 against a proposed income tax (discussed further below) motivated the Sanchez de Lozada administration

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<sup>11</sup>*El Deber*, Feb. 20, 2004: “Reconocen corrida de depósitos,” See also Paz 2007, author's interview. Sanchez de Lozada's Finance Minister in fact considered and dismissed the financial transactions tax in 2003 for fear that it might provoke massive withdrawals from the banks, given that the banking system was “very fragile.” However, he remarked in retrospect that the tax had been a revenue-raising success with none of the negative consequences for the financial sector that he had feared (Comboni 2007, author's interview).

to call on the military to restore order. Later that year, the government's plans to export gas through Chile, Bolivia's rival from the 1879-1884 War of the Pacific, sparked widespread mass uprisings, motivated by an underlying rejection of the government's economic policies and their perceived social costs. The protests, which amounted to a "nearly six-week-long social convulsion that gripped the entire nation" and resulted in over seventy deaths, forced Sanchez de Lozada to resign from the presidency in October 2003 (Arce and Rice 2009: 92).

Against this backdrop of mobilization, MAS made significant gains in congress, challenging the traditional party system. Evo Morales won a seat in the lower house in 1997, and his party won a significant minority in both the senate and the lower house in 2002.<sup>12</sup> From 2003-2006, MAS held 8 seats in the senate, while the MNR, MIR, and ADN together occupied 16 seats. In the lower house, MAS held 27 seats; the traditional parties held 66 seats.<sup>13</sup> Although few political actors or observers anticipated that Morales would win the presidency in 2006, MAS's strong showing in the 2002 elections posed a clear threat to the status quo. Furthermore, MAS's influence in the legislature could exceed the relative size of its congressional block thanks to the party's ability to mobilize its bases.

Popular sectors' mobilizational capacity counterbalanced business power at the agenda-formulation stage and subsequent stages of policymaking. Any revenue-raising proposals that might spark popular protest, such as broad-based consumption tax increases, were not feasible options for a government that wished to preserve order and maintain power. The threat of mobilization therefore removed many reforms from the agenda, leaving policymakers to choose among elite-targeted tax increases that business would likely oppose. Popular mobilization also forced reforms onto the agenda—namely, higher taxation of the hydrocarbons sector. This demand, in conjunction with calls for outright nationalization of the hydrocarbons sector, was a key component of MAS's political platform and was central to the protests that forced Sanchez de Lozada out of office. Sustained mobilization and pressure from MAS had a major impact not only on the reform agenda but also on the reform outcome.

### **The 2003 Income Tax Proposal**

In 1986, the Paz Estenssoro administration legislated far-reaching first-generation tax reform following stabilization measures to control hyperinflation. In addition to establishing a broad-based value-added tax, the reform eliminated the traditional individual income tax. In its place, the administration created a uniform tax on income, known as the RC-IVA, against which taxpayers could deduct the full value of goods and services consumed, as long as they presented receipts for their purchases to the tax agency (Cossio 2006: 89-90). The RC-IVA was designed not to tax individual income, but to control VAT evasion by encouraging consumers to request valid receipts. This reform reflected technocrats' and policymakers' assessment that the tax agency lacked capacity not only to enforce a progressive income tax, but also to administer the VAT.

Seventeen years later, President Sanchez de Lozada, who had overseen the 1986 reform as Paz Estenssoro's Finance Minister, sought to reestablish a personal income tax in Bolivia. The RC-IVA's limitations as an anti-evasion tool had been well established over the intervening years. Instead of promoting VAT compliance, this tax in practice encouraged individuals to purchase false VAT receipts (J. Nogales 2007, author's interview, Cossio 2006: 90, Coelho et al. 2004).<sup>14</sup> Consequently, the RC-IVA neither collected revenue itself,<sup>15</sup> nor enhanced VAT collections. More importantly, the absence of a personal income tax created a monumental loophole in the tax system. To mention one of the more serious problems, businesses could simultaneously avoid the corporate tax and transfer profits and income to their owners and executives free of tax by paying huge salaries, which were deductible from the corporate income tax base (author's interviews: F. Cossio 2006, Cuevas 2006). And of course, individual income represented a significant, un-tapped tax base. Sanchez de Lozada's former Finance Minister

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<sup>12</sup>On the emergence of MAS as a political party, see Van Cott 2005 (Chapter 3). On MAS as a social movement, see Yashar 2005.

<sup>13</sup>Corte Nacional Electoral. [www.cne.org.bo](http://www.cne.org.bo)

<sup>14</sup>According to Cossio (2006: 90), approximately 50% of receipts used against the RC-IVA were falsified.

<sup>15</sup>The RC-IVA collected a mere 0.3% GDP in 2003.

explained: “para ampliar la base, lo que había que hacer era justamente incorporar a sectores de altos ingresos que en ese momento no estaban tributando. Especialmente profesionales independientes, y dueños de empresas,” (Comboni 2007, author’s interview). Meanwhile, the tax agency’s administrative capacity had improved substantially, which weakened the only viable argument against establishing an income tax. In fact, a former Vice-Minister of Tax Policy and international consultant asserted that Bolivia’s tax agency had become one of the best in Latin America (J. Nogales 2007, author’s interview).<sup>16</sup>

Shortly after taking office, and facing a gaping deficit of almost 9% (Comboni 2006, author’s interview),<sup>17</sup> the Sanchez de Lozada administration designed an income tax proposal that would generate revenue amounting to 1-1.5% GDP. The income tax would consist of a flat rate of 12.5% and a single deduction, which the technical team aimed to set at four to six times the minimum wage. Thanks to the deduction, the effective tax rates paid would be progressive, rising from 3% to a maximum of 11% (Cossio 2005: 23). Individuals with incomes below the deduction level would be exempt from the tax. With a deduction equivalent to five times the minimum wage, only 32% of all wage-earners and independent professionals would pay the tax (Cossio 2005: 21). Given the large size of the informal sector in Bolivia, an even smaller percent of the economically active population would be affected—about 2.4%.<sup>18</sup>

Although the government aimed for an exemption level of 4-6 times the minimum wage, Sanchez de Lozada decided to send the proposal to congress with a lower exemption equivalent to twice the minimum wage as a bargaining strategy (Comboni 2007, author’s interview). He expected that legislators would try to increase the exemption level and wished to have room for negotiation. With this lower deduction, about 75% of wage-earners and independent professionals would pay the tax, but these taxpayers constituted only about 6% of the economically active population, still a small minority.<sup>19</sup>

### **Defeat by Popular Protest**

The income tax proposal unexpectedly provoked popular protest from a wide range of sectors, despite the fact that very few people would be subject to the tax. Organized labor had rejected the idea of an income tax early on while the government was still designing the proposal.<sup>20</sup> Morales, then a MAS deputy in congress and leader of the coca growers union, expressed support for the COB (*Central Obrero Boliviano*) and pledged *cocalero* participation in planned mobilizations against the tax.<sup>21</sup> After Sanchez de Lozada publicly announced the final design of the bill, with the deduction equivalent to twice the minimum wage, other sectors joined in the opposition, including Quispe, leader of the Aymara indigenous movement and a political rival of Morales. Events culminated in two days of demonstrations in La Paz, beginning with the police forces, and spreading to teachers unions, public employees, and university students, only a tiny fraction of whom would have been affected by the proposed tax. The government called on the military to reestablish order in La Paz; twenty-nine people were shot in the ensuing fray with the police (Gamarra 2008: 128). Civil society blamed the government for the deaths. Sanchez de Lozada responded by withdrawing the income tax proposal days later.

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<sup>16</sup>“La administración tributaria Boliviana en este momento, fruto de todos los cambios normativos y del apoyo institucional, es uno de los mejores administraciones tributarias en América Latina. El FMI lo reconoce. El BID lo reconoce. Los niveles de eficiencia, la recaudación, los niveles de eficiencia administrativa, la rendimiento en relación entre cantidad de fiscalizadores por universo de contribuyentes a fiscalizar. Es un excelente administración tributaria,” (J. Nogales 2007, author’s interview).

<sup>17</sup>See also *La Razón*, Feb. 6, 2003: “Si solo los evasores pagaran impuestos se cubriría el deficit.” This deficit resulted in large part from Sanchez de Lozada’s privatization of the pension system during his previous presidential term (1993-97). While international financial institutions had pressed the government to use proceeds from the sale of public enterprises to cover transitional costs of the pension system, Sanchez de Lozada instead used those proceeds for a capitalization fund that provided a small but universal old age pension. See Weyland (2006: 76-77).

<sup>18</sup>Author’s calculations based on Cossio (2005: 21) and INE 2003-2004. Economically active population defined as individuals aged from 15 to 64.

<sup>19</sup>*Ibid.*

<sup>20</sup>*La Razón*, Feb. 1, 2003: “El Gobierno Afina el Ajuste Tributario,” *La Razón*, Feb. 8, 2003.

<sup>21</sup>*La Razón*, Feb. 9, 2003.



### ***Strategic Errors in Reform Design***

Popular protest was partly a consequence of strategic errors in the design of the income tax proposal, which fostered misperceptions that the incidence of the tax would be broad and inequitable. First, the income tax was not clearly and visibly progressive. Instead, the flat rate suggested that everyone would pay the same amount, regardless of income level. Media coverage perpetuated this misperception. A prominent newspaper headline, for example, read: “Todos Pagaran Por Igual 12.5% de su Salario.”<sup>22</sup> Second and most importantly, insufficient targeting of economic elites undermined the government’s vertical equity appeals. In his address to the public, Sanchez de Lozada explained: “Será un impuesto que afecte a los que más ingresos tienen, a los que cobran intereses o cobran alquiler... El criterio básico ...es no dañar a los mas pobres;”<sup>23</sup> the president’s cabinet members reinforced this message.<sup>24</sup> But at the same time, the government recognized that the tax would touch middle class sectors. In the context of what the government described as a pending fiscal crisis, Sanchez de Lozada announced: “hemos pedido a la clase media que asuma este sacrificio.”<sup>25</sup> In reality, Bolivia’s middle class constituted a tiny and comparatively privileged sector of the population. Moreover, only the highest paid among middle class professionals would actually be affected. However, Sanchez de Lozada’s reference to the middle class implied that the tax’s impact would be much more broad-based, including the majority of public employees, teachers, and other working professionals. In retrospect, members of the technical team recognized this error: “If we had sent it [the bill] with [a deduction of] six [minimum wages], a lot of arguments [against the tax] would have fallen apart automatically,” (F. Cossio 2006, author’s interview).

### ***Generalized Opposition to the Government and Multiple Grievances***

A context of generalized opposition to the government from within civil society and accumulated grievances, as well as the proposal’s association with the IMF, helped catalyze the protests against the income tax. Perhaps most importantly, the unpopularity of the government itself predisposed a broad range of sectors to react negatively to the income tax proposal. Sanchez de Lozada had won only 22.5% of the popular vote in 2002; Morales finished close behind with 20.9%. Popular sectors rejected Sanchez de Lozada as the author of neoliberal reforms perceived as having deepened poverty and exacerbated inequality. As former Vice President Mesa (2006, author’s interview) recalled:

El país había llegado a la conclusión, por la campaña sistemática que se hizo contra Sánchez de Losada, que Sánchez de Losada era un vendepatria, que había entregado los recursos naturales y que era un anti-boliviano...uno de los hombres más ricos del país fuese presidente y que además hablase castellano tan mal.

Conflicts between the government and striking *cocaleros* in January further augmented anti-government sentiment: “se consideraba que el gobierno había reprimido a los manifestantes. La imagen del gobierno estaba muy deteriorada,” (Mesa 2006, author’s interview).

In this context, the income tax proposal created an opportunity for MAS and other sectors to attack the government, voice their accumulated grievances, and advance their own political agendas. Morales seized the opportunity to demand higher taxation and outright nationalization of foreign and multinational companies in the hydrocarbon sector, in line with MAS’s nationalistic and state-oriented ideology: “No es posible que la crisis económica generada por el neoliberalismo y las malas políticas económicas se descargue en las espaldas del pueblo. Esta crisis debe descargarse en las transnacionales...”<sup>26</sup> That the income tax proposal was in fact congruent with MAS’s redistributive demands was inconsequential; Morales’ priority was to defeat the political establishment and gain power, rather than to support

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<sup>22</sup>*La Razón*, Feb. 11, 2003.

<sup>23</sup>*La Razón*, Feb 10, 2003: “Goni anuncia el impuestazo y que no habra aumento salarial.”

<sup>24</sup>Minister of Sustainable Development Justiniano noted that the government had designed the proposal “ciudando de no tocar a las personas que ganan poco o que ya de por si estan empobrecidas.” Ibid.

<sup>25</sup>*La Razón*, Feb. 11, 2003.

<sup>26</sup>Morales quoted in *La Razón*, Feb. 10, 2003: “El Rechazo a las medidas es unánime.”

incremental reforms proposed by his political opponent.<sup>27</sup> The police, meanwhile, took to the streets largely because the national budget, sent to congress at the same time as the income tax bill, did not include salary increases.<sup>28</sup> The income tax was added to the list of police grievances late during the first day of the protest,<sup>29</sup> at which point other sectors opportunistically joined the demonstrations under the banner of protesting the tax.

Informants from the Sanchez de Lozada administration included the media among those sectors seeking to weaken the government. Members of the technical team accused the media of manipulating coverage of the reform; according to the former Finance Minister: “había una intencionalidad política en contra del gobierno, que en realidad aprovecharon el momento para hacerla,” (Comboni 2007, author’s interview). Whether or not the media acted deliberately, news coverage did reinforce misperceptions regarding the incidence of the income tax. For example, the media consistently referred to the income tax as an “impuesto al salario,” which appeared to place all of the burden on wage earners, rather than a tax on all source of income including rents and interest, which would affect the richest Bolivians. Civil society leaders regularly reiterated these misperceptions, whether in response to media coverage and genuine confusion<sup>30</sup> or simply on the pretext of opposing the government. A COB leader, for example, asserted in the press: “Como obreros rechazamos el impuesto al salario porque va a profundizar la pobreza,”<sup>31</sup> while another denounced: “Nuevamente se carga en la espalda de los trabajadores la responsabilidad económica, política y social del país.”<sup>32</sup> Quispe even decried that campesinos would ultimately bear the cost of the tax.<sup>33</sup> None of these statements were technically substantiated.

Association with the much-maligned neoliberal model and IMF also contributed to rejection of the proposal. The proposal was announced while the government was engaged in negotiations with the IMF. Sanchez de Lozada and his technical team believed that the income tax was necessary and intended to implement it independently of the IMF’s recommendations. However, as the former Finance Minister recalled: “implícitamente quedo claro que esto estaba vinculado con un arreglo con el FMI. Entonces salio como una imposición de parte del FMI.” (Comboni 2007, author’s interview). Many of the popular sector organizations that opposed the tax bill made explicit reference to the IMF’s supposed involvement. The COB for example denounced: “El gobierno esta llevando adelante las recomendaciones e imposiciones del FMI...”<sup>34</sup>

In retrospect, a technical team informant provided the following assessment of factors contributing to the February protest: “the political motives ...were 75% of the problem, 15% was the budget law, and 10% was the tax law.” In his opinion, “looking back, I think that it was just too good of a pretext... The population was misinformed enough to ...believe that this [tax] was evil, it was too good of an opportunity to use that even if we had sent [an exemption of] five minimum salaries, I think things would have been pretty much the same,” (F. Cossio 2006, author’s interview). Mesa’s former Finance Minister offered a similar assessment: “El reclamo que hicieron se debía a dos factores: primero, que fue muy mal explicado el impuesto, segundo, que hubo una reacción que fue aprovechado políticamente,” (Cuevas 2007, author’s interview).

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<sup>27</sup>MAS did however support some elements of government legislation, including some articles of the tax code reform later passed by Sanchez de Lozada (F. Cossio 2006, author’s interview). Interestingly, one MAS representative recognized the value of the income tax proposal, despite the party’s decision to oppose it. According to a member of Sanchez de Lozada’s technical team, this representative told his compatriots after the government’s explanation that MAS should support the tax proposal because it would be good for poor people.

<sup>28</sup>The police demonstrations on February 12 explicitly denounced the budget and demanded a 40% pay increase.

<sup>29</sup>*La Razón*, Feb. 12, 2003: “La Policía se Amotinó.”

<sup>30</sup>A leader of the COB (2006, author’s interview), for example, conveyed a complete lack of understanding of tax policy.

<sup>31</sup>Quoted in *El Deber*, Feb. 6, 2003: “Otro impuesto al salario generará más evasión de contribuyentes.”

<sup>32</sup>Quoted in *La Razón*, Feb. 10, 2003: “El Rechazo a las medidas es unánime.”

<sup>33</sup>Quispe asserted: “...la medida del impuesto nos perjudica a todos. Por el momento no afectara al sector campesino, pero el golpe será después, más adelante, cuando las personas no tengan dinero para poder consumir nuestros productos agrícolas.” *La Razón*, Feb. 11, 2003.

<sup>34</sup>*La Razón*, Feb. 10, 2003: “El Rechazo a las medidas es unanime.”

## **Business Opposition**

Given the eruption of popular protest, business played no relevant role in the demise of the 2003 income tax reform. However, it is important to note that business opposed the proposal (Mustafa 2006, author's interview), just as business would oppose Mesa's assets tax proposal a year later. The CEPB and the Santa Cruz business peak associations alike denounced the tax, arguing that it would deepen the economic recession and even force businesses to close due to contraction of demand for their goods and services.<sup>35</sup> While these arguments were not entirely devoid of technical merit, if greatly overstated, business opposition may also have responded to the interests of individual capital owners who would be affected by the personal income tax. This class-cohesive phenomenon, whereby business associations defend the interests of individual capital owners, will be more evident in the case of Mesa's assets tax proposal, discussed below.

Business made clear its plans to lobby against the reform in congress prior to the mass protests and the administration's decision to withdraw the proposal. Business's preliminary efforts even included meetings with MAS. The president of the CEPB, Carlos Calvo, met with Morales in La Paz to discuss the possibility of joint opposition to the measure; Branco Matkovic, president of CAINCO in Santa Cruz, agreed that business should join forces with MAS against the tax.<sup>36</sup> Meanwhile, business associations in Santa Cruz met with the departmental branch of the COB to discuss opposition to the tax. Had Sanchez de Lozada not withdrawn the proposal from congress, MAS and the labor unions might have served as contingent business allies in opposing the tax.

## **The Legacy of the 2003 Proposal**

The protests sparked by the 2003 income tax proposal have had a lasting impact on Bolivian policymakers. Technocrats in the Mesa administration and even the Morales administration agreed that Bolivia should have a personal income tax, but all felt that pursuing this objective entailed major risks of renewed popular protest, notwithstanding the fact that a tiny fraction of the population would be affected (author's interviews: Cuevas 2007, VMPT A 2006, 2007). Remarkably, an article hidden from the public eye in a reform package passed by the Sanchez de Lozada administration later in 2003 granted the executive decree power to reduce the percentage of receipts creditable against the RC-IVA. This measure allows the executive to transform the RC-IVA into a crudely-designed income tax without need for congressional approval or any public deliberation, simply by reducing the fraction of creditable receipts to zero, either immediately or gradually (Cossio 2006: 90). Yet the legacy of the 2003 protest is so strong that no subsequent administration has yet dared to use this authority. In fact, a strong taboo surrounds the issue of the individual income tax in Bolivia. The Catholic Church has shown interest in the income tax as a progressive and redistributive reform (Fundación Jubileo 2006: 18), yet representatives are reluctant to discuss the matter in public (author's interviews). The income tax simply lacks legitimacy in the eyes of public due to its close association with the IMF and former President Sanchez de Lozada, which are emblematic of the repudiated former economic model and political system. No government wishes to introduce a tax reform that in any way resembles the failed initiative proposed by Sanchez de Lozada, "el enemigo público número uno" (Mesa 2006: author's interview), who was convicted in absentia in Bolivia for "crimes against humanity" in relation to deaths during the October uprising.

## **The 2004 Assets Tax and Financial Transactions Tax Proposals**

When Mesa assumed the presidency after Sanchez de Lozada's resignation, the government faced a 9% budget deficit (Cuevas 2007, author's interview) and high levels of socio-political instability. The government proposed two taxes to raise revenue: an individual net assets tax, and a tax on financial transactions. These taxes were explicitly designed to avoid popular protest. However, the assets tax,

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<sup>35</sup>*La Razón*, Feb. 4, 2003: "La Crisis se va a Profundizar," *El Deber*, Feb. 1, 2003, *La Razón*, Feb. 11, 2003: "Los salarios se achican, la banca teme por la mora y el ahorro."

<sup>36</sup>*La Razón*, Feb. 12, 2003: "Resistencia a la renta al salario unen a emprs y trabajadores," *El Deber*, Feb. 12, 2003: "El impuesto une a Evo y los empresarios."

which visibly targeted economic elites, instead stimulated broad business opposition. Business's instrumental power, arising from informal ties to the traditional political parties with representation in congress and bifurcated cohesion, contributed to the demise of the assets tax by facilitating coordinated business lobbying and coordinated business-party opposition, similar to the dynamic observed in Chile with regard to the 2000 Anti-Evasion Reform. The administration was compelled to grant multiple concessions that denatured the assets tax proposal; the modified version was nevertheless rejected in congress. Lack of support from MAS—the leftist opposition—and the absence of popular mobilization in favor of reform also contributed to the fate of the assets tax. Although business also opposed the transactions tax, it was viewed as the lesser of two evils. The government's strategy of emphasizing stabilization secured tacit business acceptance of the transactions tax and acquiescence from the traditional party legislators in congress.

### **Designing Reform to Avoid Popular Protest**

One of President Mesa's primary considerations in designing the 2004 reform proposal was to avoid renewed popular protest in the aftermath of the October 2003 uprising. Mesa quickly ruled out a suggestion from one member of his technical team to increase gas prices (X. Nogales 2007: authors interview), which were subsidized by the state, given the likelihood that a reform with broad-based impact would stimulate widespread popular rejection and potentially protest. Like the previous administration, Mesa and his Finance Minister believed that Bolivia needed a personal income tax, but reintroducing a similar proposal was not feasible either after the events of February 2003. As Mesa (2006, author's interview) recounted: "El impuesto de Goni, que era muy moderado, demostró de una manera brutal que efectivamente no había esa posibilidad. Nosotros no quisimos ...arriesgarnos nuevamente a una medida que había sido rechazada de una manera tan dramática." The government's revenue-raising tools would have to be even more targeted—and more clearly targeted—at economic elites.

The assets tax and the transactions tax satisfied these criteria. The technical team designed the individual assets tax to have a very high exemption level of USD 50,000.<sup>37</sup> There was little room for confusion regarding the incidence of the tax; the vast majority of the population was patently excluded from the tax base. According to one of the authors of the reform, the assets tax would affect only about 3% of the population (J. Nogales 2007, author's interview), whereas the income tax (in the form sent to congress) would have affected about 6% of the population. And in contrast to the income tax, it was impossible to misconstrue the assets tax as a burden solely on wage earners. The assets tax would instead apply to land, homes, vehicles, and other visible accumulations of wealth (among other less visible assets like stocks). The transactions tax also appeared to affect a tiny minority of Bolivians who maintained bank accounts, although as an indirect tax, its actual incidence is difficult to assess. According to the Finance Ministry's calculations, 80% of the funds in bank deposits were concentrated in the hands of only 5% of all account holders (Cuevas 2007, author's interview).

The administration made ample use of vertical equity appeals to preclude the possibility of popular opposition, emphasizing that only the rich would have to pay, and explicitly noting that other alternatives would have affected a larger swath of the population. Consider the following statements made by President Mesa in the press:

Los impuestos afectan a quienes tienen más ingresos, al sector informal de la economía que no le ha gustado en el pasado pagar impuestos y no al sector informal de la señora que vende en la calle.<sup>38</sup>

Mi misión ética es que ambos impuestos ...tienen el objetivo de no golpear a los mas débiles y a los mas pobres, evitar un gasolinazo y evitar un garrafazo.<sup>39</sup>

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<sup>37</sup>*La Razón*, Feb. 12, 2004: "El Gobierno espera recaudar USD 70 millones."

<sup>38</sup>*El Deber*, Feb. 9, 2004.

<sup>39</sup>*La Razón*, March 12, 2004: "La crisis política acorralla a mesa."

A “*garrafazo*” would have entailed increasing the price of basic household fuel canisters, a highly regressive and broad-based revenue-raising alternative. The Minister of Sustainable Development directed similar vertical equity appeals at the legislators: “El país tiene un desafío por delante y el gran apoyo que nos tiene que dar el Congreso es de cobrarle a los que mas tienen y no a los que menos tienen.”<sup>40</sup>

The design of the taxes and the government’s vertical equity appeals successfully precluded popular opposition. The proposal did not incite protests, and informants from the Mesa administration felt that the public in general accepted the measure. However, as discussed below, the assets tax provoked broad and intense opposition from business. Thinking back on the government’s decision to propose the assets tax, a member of the technical team reflected: “Se lo veía [el impuesto neto al patrimonio] como factible políticamente. Lo que pasa es que vemos más esto desde el lado de quienes no iban a rechazar. Pero resultado que los que rechazaron, rechazaron con mucha fuerza. Probablemente más allá de lo que esperamos,” (J. Nogales 2007, author’s interview).

### **Broad Business Opposition to the Assets Tax**

The assets tax, which was highly targeted and visible, threatened shared class interests and elicited intense opposition. Organized business, including both the CEPB and the Santa Cruz peak associations, denounced the tax proposal. Opposition was strongest from the landowners in Santa Cruz, whose economic interests were most threatened by the assets tax, but business opposition was both cross-regional and cross-sectoral. The context of a growing redistributive threat posed by mobilized popular sectors and the rise of MAS likely intensified business’s class-defensive response to the assets tax, which can be considered a classic case of the sort that motivated Ascher (1984: 228) to observe: “Clarity, when it mobilizes a powerful opposition, is counterproductive” for redistributive reforms.

The class-based nature of business opposition is particularly striking given that the assets tax was designed to affect only individuals, not businesses. As in Chile, and in contrast to Argentina, Bolivian business associations defended the interests of not only companies, but also their owners and economic elites more generally. Several informants explained the associations’ opposition to the assets tax by noting that business people are themselves also property owners (author’s interviews: CAINCO A 2007, Ortiz 2007). The blurring of lines between business interests and individual interests is also evidenced in the business associations’ repeated assertions that the assets tax would affect business assets, in stark contradiction to the text of the proposal. Although the government repeatedly clarified that the assets tax would apply exclusively to individuals (Cuevas 2006, author’s interview),<sup>41</sup> business leaders consistently claimed or implied that the tax would affect business assets (author’s interviews: Mustafa 2006, Ortiz 2007, Yovhio 2007, Dabdoub 2007, Marinkovic 2007, Matkovic 2007).<sup>42</sup> Claiming that the tax included business assets allowed business associations to argue that the assets tax would harm investment and threaten jobs,<sup>43</sup> which served to legitimate business opposition, even though the administration’s technical team did not perceive structural power to be an issue.

Class-based opposition to the assets tax did not heal the regional division within the business community. In fact, the FEPB-SC withdrew from the CEPB in the midst of the national debate surrounding the assets tax, in part due to the CEPB’s express willingness to support Mesa’s economic plan and to negotiate the terms of the taxes with the government. The Santa Cruz peak associations, in

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<sup>40</sup>Xavier Nogales quoted in *La Razón*, Feb. 20, 2004: “Gobierno pide al Congreso aprobar nuevos tributos.”

<sup>41</sup>Vice Minister of Tax Policy Jose Antonio Nogales clarified that “el impuesto al patrimonio no es para las empresas, sino para las personas; por tanto, la reaccion de Santa Cruz no tiene sentido, salvo que los mismos empresarios tengan gran riqueza acumulada,” (*La Razón*, Feb. 18, 2004: “Más impuestos y el apoyo a Mesa dividen a empresarios.” See also *El Deber*, Feb. 18, 2004: “Alertan posible fuga de empresas a paraísos fiscales.”

<sup>42</sup>See also *Ibid.* and *El Deber*, March 6, 2004: “Patrimonio de empresas se salvaron.”

<sup>43</sup>These arguments are reflected in the following passage from an interview with a former MIR deputy: “a mi me tocó apoyar la posición de los empresarios de Santa Cruz, pero por un principio importante que me parecía sólida y fuerte como argumento. No es conveniente para Bolivia cerrar fuentes de empleo. Hay que preservarlas, y este tipo de impacto tributario lo que hace es restringir la capacidad de inversión,” (Soruco 2006, author’s interview).

contrast, pursued a strategy of intransigently rejecting the assets tax, which they denounced as placing the bulk of the burden of fiscal adjustment on their own department.<sup>44</sup> It should be emphasized, however, that despite the CEPB's more conciliatory stance with respect to the government's proposals, the national peak association clearly rejected the assets tax (author's interviews: Mustafa 2006, Sanchez 2007, Matkovic 2007).<sup>45</sup>

The government's horizontal equity appeals failed to win business support, given the direct threat the tax posed to their class interests. The government argued that the assets tax would capture the large fish in the informal sector within its net, given the comparative ease of detecting physical assets as compared to income.<sup>46</sup> But business countered the government's assertions by claiming that the tax agency would not be able to effectively collect the tax and arguing that instead of creating new taxes, the simplified regimes for small taxpayers should be eliminated in order to curtail evasion by larger firms illegally registered under these regimes. Business in effect argued the informal sector alone should bear the full burden of any revenue-increasing measures.<sup>47</sup> While Mesa's former Finance Minister did assert that horizontal equity appeals contributed to less intense rejection from business in La Paz compared to Santa Cruz (Cuevas 2006, author's interview), the peak associations from both departments continued to actively oppose the tax.

### **Business's Instrumental Power: Coordinated Opposition and the Demise of the Assets Tax**

Cross-sectoral cohesion and links to the traditional parties facilitated coordinated business lobbying and a united business-traditional party opposition front. Given the regional division, the CEPB and the Santa Cruz peak associations undertook decidedly independent initiatives; the FEPB-SC announced with fanfare after withdrawing from the CEPB that it would negotiate separately with the government.<sup>48</sup> However, the respective lobbying efforts mounted by the two business blocks were highly coordinated. The CEPB was the primary interlocutor with the government for business beyond Santa Cruz. The peak association engaged in regular dialogs with the administration in pursuit of concessions,<sup>49</sup> and the CEPB's directorate met frequently to define consensus positions as the government's tax proposal evolved through various stages.<sup>50</sup> Meanwhile, CAINCO and the FEPB-SC sustained constant pressure against the assets tax. Statements made by the leaders of these associations in the press were often nearly identical in content, demonstrating a high level of coordination and consensus from organized business in Santa Cruz.

The traditional political parties meanwhile defended business's interests in congress. Informants from the Mesa administration frequently referred to the traditional party legislators as representatives of business as well as economic elites more broadly. The former president asserted: "quienes hicieron un lobby para bloquear ese impuesto fueron los sectores más ricos del país. A través de sus representantes parlamentarios," (Mesa 2006, author's interview). Members of his technical team made similar comments regarding the business-traditional party nexus (author's interviews: J. Nogales 2007, Cuevas 2006). Business informants likewise acknowledged the importance of their lobbying efforts with the MNR, MIR, and ADN (Matkovic 2007, author's interview).

Business in Santa Cruz achieved a particularly impressive level of coordination with the traditional political parties. The former head of the Santa Cruz parliamentary brigade, a MIR deputy, openly described the legislators' collaboration with the peak associations:

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<sup>44</sup>*El Deber*, Jan. 3, 2004: "Sectores cruceños se declaran en emergencia por mensaje de Mesa."

<sup>45</sup>See also "Convenio Entre el Gobierno Nacional, La Confederación de Empresarios Privados de Bolivia y Representates de Federaciones, Camaras Nacionales y Departamentales," *La Paz* March 1, 2004, and *El Deber*, March 2, 2004: "Ejecutivo acepta criticas de los empresarios y revisara las leyes."

<sup>46</sup>The Minister of Sustainable Development, for example, announced: "por primera vez estamos poniendo un impuesto a aquellos que han acumulado riqueza, aunque sea informalmente. O sea no es solo a los grandes contribuyentes," (*La Razón*, Feb. 3 2004: "Impuesto al patrimonio ira solo por este año").

<sup>47</sup>CAINCO (2004a: 5-6) emphasized fighting contraband and broadening the tax base by better controlling the simplified tax regimes, as well as cutting government spending, as alternatives to creating new taxes.

<sup>48</sup>*La Razón*, Feb. 28, 2004.

<sup>49</sup>See for example *La Razón*, March 3, 2004.

<sup>50</sup>See for example *La Razón*, March 9, 2004: "El Consejo Directivo evaluo los proyectos de ley."

--*Cuánta coordinación había entre la bancada de Santa Cruz y los gremios empresariales?* Muy estrecha. Muy estrecha. Este fue uno de los temas que trabajamos muy de cerca con el equipo de gente de la CAINCO, de la FEBP-SC, Branco Marinkovic. Con él trabajamos en esos temas, como en tantas otras. (Soruco 2007, author's interview).<sup>51</sup>

As the struggle against the assets tax progressed, overt business-party coordination extended throughout the *media luna*. In early March, legislators and business leaders from Santa Cruz, Tarija, Pando, Beni and Chuquisaca held a five-hour meeting and issued a joint statement rejecting the assets tax.<sup>52</sup> Many of the traditional party legislators in congress were elected from these five departments. As Mesa remarked: “el lobby del empresariado, particularmente cruceño, era muy fuerte en la representación de los partidos que en ese momento tenían mayoría en el Congreso, el MNR y el MIR, que me iban a bloquear la medida.”

Facing broad business opposition and lacking votes from the governing coalition in congress, the administration was compelled to negotiate concessions directly with business. At the beginning of March, the government met with the CEPB and agreed to revise the assets tax proposal. The CEPB “dejo claro su total desacuerdo”<sup>53</sup> with the tax and demanded various modifications that would restrict its base, including exemptions for stocks and savings accounts.<sup>54</sup> CAINCO and the FEBP-SC, meanwhile, declined to recognize the CEPB-government agreement and continued to demand the withdrawal of the assets tax proposal. Still facing opposition in congress, particularly from legislators representing the *media luna*, the administration granted a major concession to the landowners of the lowland departments: Mesa's technical team redesigned the assets tax as a tax on urban property, entirely exempting agricultural land.<sup>55</sup> This radical measure met with applause from the CAO, but the Santa Cruz peak associations nevertheless opposed the alternative property tax (CAINCO 2004a: 2, author's interviews: Saavedra 2007, CAINCO A 2007).

Not only did the government's concessions fail to appease the intransigent Santa Cruz peak associations, but the modifications to the assets tax also incurred popular censure, due to the erosion of vertical equity. The modified property tax, like the original assets tax, would leave most of the population untouched, but it now also exempted those perceived as the wealthiest in Bolivia. As a member of Mesa's technical team recalled: “la critica de la opinión publica fue muy fuerte. Se criticó porque se pensó que se estaba favoreciendo a la oligarquía terrateniente del oriente del país y todo un discurso: ‘cada vez mas se había ganado la oligarquía terrateniente hacendaria,’” (J. Nogales 2007, author's interview). Given continued business opposition and popular rejection, legislators voted down the property tax proposal in congress.

### **Absence of Support from MAS and Popular Sector Organizations**

In contrast to other cases in Bolivia and beyond, no political actor lent support to the assets tax proposal. Whereas in Chile, Concertación governments could usually count on support from their center-left legislators in congress for progressive tax reforms, Mesa faced opportunistic opposition from MAS, Bolivia's emerging left party. While MAS supported Mesa to a limited extent on some issues,<sup>56</sup> Morales' priority was establishing MAS as an electoral alternative to the traditional political elite and differentiating his party from the presiding government, with an eye toward winning the presidency. Although the assets tax was ostensibly congruent with MAS's redistributive agenda, supporting this proposal was not a political priority. MAS remained largely silent on the issue while Mesa struggled to mollify business and align the traditional parties. When the government exempted rural land from the tax, MAS seized the opportunity to criticize Mesa for giving in to the landed oligarchy, implicitly supporting

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<sup>51</sup>See also *El Deber*, Jan. 3, 2004.

<sup>52</sup>*El Deber*, March 9, 2004: “Cinco regiones se unan contra tributos de Mesa.”

<sup>53</sup>*El Deber*, March 2, 2004: “Ejecutivo acepta criticas de los empresarios y revisara las leyes.”

<sup>54</sup>*El Deber*, March 3, 2004: “Diputados dan por hecho que nuevos tributos seran revisados.”

<sup>55</sup>*La Razón*, March 6, 2004: “Las transnacionales también pagarán el nuevo impuesto.”

<sup>56</sup>For example, Morales supported Mesa's July 2004 hydrocarbon referendum and the government's position on several (but not all) of the questions included (MESA 2006, author's interview).

the original version of the assets tax but only after the fact (Cuevas 2007, author's interview).<sup>57</sup> Like the traditional parties, MAS opposed the revised property tax in congress, as well as the financial transactions tax, arguing that the government should increase taxation of hydrocarbons instead, a central component of MAS's own political platform and an issue that resonated broadly with the popular sectors and the public at large.<sup>58</sup>

Further, whereas popular sectors, often under the direction of MAS, mobilized in favor of nationalizing the hydrocarbons sector, the assets tax did not inspire mass demonstrations of support. Mesa's vertical equity appeals precluded popular mobilization against the tax, but despite his high levels of support in public opinion polls, he did not have the ability to physically rally popular sectors to his agenda. As the former president recalled: "...yo llevaba dos meses y medio en el gobierno y todavía mi posicionamiento no era lo suficientemente claro en los sectores populares—que me veían con buenos ojos, pero que no iban a salir a las calles para defender mis medidas..." (Mesa 2006, author's interview). As with MAS, leaders of popular sector organizations remained silent until the government had lost the battle:

Quando se quedó descartada y sólo se aprobó el impuesto a las transacciones financieras, allí sí mucha gente que había guardado silencio antes, sobre todo como comunicadores sociales, valoró que la propuesta impuesto al patrimonio neto era en este contexto lo mas justo que se podía hacer. ... Y criticaron inclusive al gobierno porque no fue firme.... Pero apoyo no hubo. El problema es que ese gobierno al que se criticaba, cuando estaba peleando el tema, nadie lo apoyaba. (J. Nogales 2007, author's interview)

### **Emphasizing Stabilization Secures Business Acceptance of the Transaction Tax**

Whereas organized business soundly rejected the assets tax, business ultimately accepted the financial transactions tax. First, business viewed the transactions tax as the lesser of two evils (author's interviews: Dabdoub 2007, Marinkovic 2007, Matkovic 2007, Ortiz 2007, among others). The lower visibility of this tax and its less certain incidence as compared to the assets tax may have contributed to less intense business rejection, despite the fact that both taxes would raise comparable amounts of revenue. The transactions tax did not single elites out as a class to the same degree as the assets tax, and businesses would likely be able to pass on some of the burden of the transactions tax to labor or consumers, whereas the assets tax would directly affect the owners' pocketbooks.<sup>59</sup>

Second, as with the transactions tax in Argentina (Chapter 6, Part 1), the government's emphasis on the importance of the taxes for fiscal stability convinced business that at least some compromise on taxation was imperative. The administration regularly emphasized the gaping budget deficit and the potentially devastating consequences of failing to raise tax revenue; feasible spending cuts and austerity

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<sup>57</sup>Morales declared in the press: "En el tema de impuestos coincidimos con la visión del Presidente, pues los impuestos tiene que ser para los que tienen mayores recursos económicos. Cuando se excluye a la gente que tiene muchas tierras, el que no paguen, no está afectando a la gente pudiente. En las negociaciones se ha excluido la propiedad de tierras. Que por lo menos paguen impuestos," (*La Razón*, March 15, 2004: "El MAS pide impuestos para terratenientes"). Likewise, MAS Deputy Torrico declared: "el Gobierno ha retrocedido ante las presiones de un sector y ahora pretende ampliar la carga imp al resto," (*La Razón*, March 6, 2004: "Las organizaciones critican la falta de firmeza del Presidente"). See also Senado, 87 Sesión Ordinaria, March 11, 2004.

<sup>58</sup>Senado, 87 Sesión Ordinaria, March 11, 2004.

<sup>59</sup>Ironically, however, Sanchez de Lozada's former finance minister pointed out that the transactions tax would affect businesses as organizations more than the assets tax, given that businesses would be the subjects of the former tax but not of the latter tax (Comboni 2007, author's interview). Assessments of the transactions tax's horizontal equity varied across informants. Mesa's Finance Minister expressed the opinion that the assets tax would have incorporated members of the informal sector more effectively than the transactions tax, based on the presumption that potential informal sector taxpayers did not use the financial system (Cuevas 2006, author's interview). CAINCO (2004a: 4) and a representative of the exporters associations CADEX also asserted that the transactions tax differentially affected the formal sector (Barriga 2007, author's interview). The president of the CEPB, in contrast, asserted that the transactions tax would apply to both the formal and informal sectors (Mustafa 2006, author's interview). If firms and entrepreneurs in the informal sector did in fact deposit funds in the financial system, they would be forced to pay the tax; whereas the assets tax could in theory be evaded, the transactions tax was withheld directly by the banks.



alone could not make up the shortfalls. The government's appeals grew increasingly urgent as the tax proposals came to vote in congress. A major newspaper, for example, reported:

El Gobierno advirtió de una inminente iliquidez del Tesoro General de la Nación si acaso el Parlamento no aprueba hasta fin de mes los proyectos... Inclusive las autoridades del Poder Ejecutivo alertan sobre una nueva espiral inflacionaria en el país, como la vivida entre 1982 y 1985, cuando la moneda nacional se llegó a devaluar hasta en un 25,000 por ciento.<sup>60</sup>

In a country that had experienced hyperinflation in the recent past, business could not completely ignore the government's need for revenue. The former president of CAINCO pointed out the imperative of compromise once the defeat of the assets tax had been secured: "si estabas tumbando un impuesto al patrimonio, algo se tenía que al final de cuenta ya negociar," (Matkovic 2007, author's interview). The financial sector, which had the most to lose from inflation, was particularly responsive to the government's appeals. Despite concerns that the transactions tax could discourage use of the financial system, the sector accepted the measure as necessary (Cuevas 2007, author's interview).<sup>61</sup> As the general manager of the national banking association's Santa Cruz branch explained: "At that time we were running a deficit of more than 5%... And well, in a way we of course oppose it, but we knew that... being of absolute necessity to reduce the level of the deficit, we finally negotiated what we could in order to get clear terms for the transactions tax when it was applied," (ASOBAN A 2007, author's interview). The CEPB and the Santa Cruz peak associations also accepted the transactions tax, after securing various modifications to the proposal. Informants from these associations all identified the deficit as the primary motivation (author's interviews: Mustafa 2006, Dabdoub 2007).

### **The 2005 Hydrocarbon Reform**

In 2005, the Bolivian congress legislated a new hydrocarbons law that dramatically increased taxation of this extractive sector. A 1996 reform to the Hydrocarbons Law had reduced royalties from 50% to 18% to encourage investment and exploration.<sup>62</sup> Along with far-reaching changes that expanded the state's role in regulating the sector and obliged companies to renegotiate their contracts with the state, the 2005 reform created a new "direct tax" of 32% of the value of production. Hydrocarbons companies subsequently paid total effective tax rates of approximately 56%, including VAT, other indirect taxes, and corporate taxes (VMPT A 2006, author's interview), whereas their effective tax burdens had previously ranged from 28% to 35% (Mesa 2006, author's interview). A contrast with taxation of copper extraction in Chile highlights the impressive magnitude of Bolivia's hydrocarbon tax increase. Chile's new "specific tax on mining," legislated in the same year, was a mere 4%, applied not to the value of production but to profits, a narrower tax base (Chapter 4, Part 3).

Popular sector mobilization in Bolivia played a critical and direct role in producing this remarkable tax increase. In a context of social and political upheaval, mass mobilization in demand of not only higher taxation of hydrocarbon extraction, but even outright nationalization, overwhelmed business's substantial power. Popular sector mobilization and sustained pressure from MAS forced the issue of hydrocarbon taxation onto the national agenda and subsequently motivated congress to legislate a much harsher law than the executive had proposed.

### **Business Power: Weaker Cohesion but Stronger Structural Power**

As in the cases discussed previously in this chapter, business power with respect to the hydrocarbons reform was substantial. However, two aspects of business power differed and are worthy of attention. First, business cohesion was weaker, and second, structural power was stronger.

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<sup>60</sup>*La Razón*, March 10, 2004.

<sup>61</sup>See also *La Razón*, Feb. 3, 2004: "Banca da su visto bueno al tributo a las transacciones," *La Razón*, Feb. 21, 2004: "Santa Cruz frena el plan Mesa y la banca lo apoya con reparos."

<sup>62</sup>The lower rates were applicable only to new fields.

Business cohesion was weaker with respect to the hydrocarbons law reform as compared to the 2004 assets tax proposal because the former issue more effectively primed the regional cleavage within the business community. Whereas both the CEPB in La Paz and the Santa Cruz peak associations actively opposed the assets tax, the CEPB in practice did not play a role in the political process surrounding the hydrocarbons reform, aside from issuing a few statements regarding the need to respect contracts and the rules of the game for foreign investment (Jemio 2006, author's interview). Business leaders in La Paz were open to the possibility of taxing the hydrocarbons sector more heavily. On the one hand, additional revenue from the foreign and multinational hydrocarbon companies would make the government less inclined to increase taxes on the domestic business sector.<sup>63</sup> On the other hand, the CEPB recognized that the hydrocarbon sector's privileged tax status was a time bomb: "hubo una declaración del presidente de entonces [de la CEPB] de que [la empresas petroleras] debieran pagar más, que era muy poco, y aconsejaba el presidente de la Confederación de que ellos voluntariamente subieran sus impuestos antes de que haya una reacción popular. Como la que ha habido!" (Mustafa 2006: author's interview). The CEPB's position provoked the Cámara de Hidrocarburos to withdraw from the national confederation, adding an organizational dimension to the cleavage (author's interviews: Mustafa 2006, Kieffer 2007). In Santa Cruz, in contrast, the peak associations played a much more active role in defending the hydrocarbons companies (Jemio 2006, author's interview), whose operations were physically located in their department. Although the multinational hydrocarbon companies were not members of CAINCO or the FEPB-SC, the domestic business community in Santa Cruz was quite concerned over respect for contracts and legal security ("seguridad jurídica") for self-interested reasons. The agricultural sector in particular feared that violation of contracts signed with hydrocarbons companies would portend future violations of their own property rights, in a context of growing domestic conflict over land tenure (Eaton 2007, author's interviews: Kieffer 2007, Nuñez 2007). In addition, although businesses in Santa Cruz also preferred higher taxation of hydrocarbons multinationals to higher taxation of their own operations (X. Nogales 2007, author's interview),<sup>64</sup> many domestic businesses in the department provided services to the hydrocarbons sector, and their economic interests were therefore aligned (G. Torres, author's interview, Eaton 2007).

But while business's instrumental power was weaker than in previous cases, structural power was stronger. The executive branch, along with a sizable block of representatives in congress, perceived a credible threat that the radical tax increases and substantially greater role for the state in the hydrocarbons sector demanded by popular sectors and MAS would lead to reduced investment in the sector (author's interviews: Mesa 2006, Jemio 2006). President Mesa and his cabinet members recognized that despite its problems, the 1996 reform had been tremendously successful at attracting foreign investment; reserves had multiplied dramatically during the following years (author's interviews: X. Nogales 2007, Mesa 2006).<sup>65</sup> Attracting additional foreign investment in the hydrocarbons sector was critical since Bolivia lacked the capital and the expertise to develop its reserves of natural gas. Meanwhile, some legislators from the MNR and MIR, especially those representing Santa Cruz, even worried that these changes could provoke the multinationals already operating in Bolivia to leave the country (J. Torres 2007, author's interview).

As discussed below, structural power initially restricted the executive's agenda, and business's instrumental power, though weakened by the regional division, also created substantial pressure to protect the hydrocarbon sector's interests. However, popular mobilization in favor of radical reform was the more compelling consideration for policymakers in a context of imminent social upheaval.

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<sup>63</sup>As the president of the Cámara de Hidrocarburos recalled: "algunos grupos empresariales decían cuanto más paguen los petroleros, que son multinacionales, menos reformas de ajuste va a ver para nuestro sector. Algunos decían oh, que bueno que paguen más. Por que esto va a hacer que a nosotros no nos quieren subir el IVA o el Impuesto a las Utilidades," (Kieffer 2007, author's interview).

<sup>64</sup>X. Nogales (2007, author's interview), one of Mesa's first Hydrocarbons Ministers, in fact asserted that none of the Bolivian business community supported the hydrocarbon companies, notwithstanding statements about respecting contracts and legal security.

<sup>65</sup>Proven natural gas reserves in 2002 were more than twelve times larger than in 1995 (Pacheco 2004: 187).

## Popular Mobilization Overwhelms Business Power

Nationalization or at least much higher taxation of hydrocarbons had become an integral component of popular sector demands by 2003. The state hydrocarbons company had been capitalized on terms popularly perceived as extremely favorable to transnationals in 1996.<sup>66</sup> Although the reforms contributed to tremendous growth in the sector and discovery of vast new reserves, foreign ownership and under-taxation of the hydrocarbons sector came to embody all of the perceived evils inherent in Bolivia's neoliberal model: foreign and multinational companies reaped massive profits from exporting the country's natural resources, the state received a pittance in remuneration, and the majority of Bolivians continued to suffer poverty and socio-economic exclusion. As Lazarte (2005: 447) observes: "La importancia movilizadora del gas se comprende por el contexto. En situación de pobreza, de desigualdades crecientes y de crisis económica, el gas apareció para muchos sectores de la población como la última oportunidad para enfrentar los problemas del país." Nationalist sentiments enhanced the mobilizational potential of the hydrocarbons issue; Arce and Rice (2009: 96) note the "deep-seated rejection of neoliberalism as a form of neocolonialism" with which the prevailing hydrocarbons regime was associated.<sup>67</sup>

The wave of mobilizations that constituted the October 2003 uprising, known as the "gas war," forced the issue of hydrocarbon taxation onto the national agenda. In addition to calling for a constituent assembly, popular sectors including MAS (led by Morales), MIP (lead by Quispe), and the COB, demanded reform of the hydrocarbons law to increase the country's income and a referendum on the issue of exporting natural gas (Lazarte 2005). President Sanchez de Lozada, the author of the 1996 reform, had no intention of revising the hydrocarbons law, although several clarifications and elaborations were planned that would have helped resolve the problem of hydrocarbon under-taxation.<sup>68</sup> Sanchez de Lozada declined to address the popular sectors' demands until the conflict had escalated beyond control (Lazarte 2005: 451). In the wake of the final massive demonstrations that forced Sanchez de Lozada to resign, Mesa, his successor, embraced the three core elements of the so-called "October agenda"—the new president voiced his commitment to hold a referendum on hydrocarbon policy and to substantially revise the 1996 law. Given that protests over these issues had forced the country to the brink of chaos, it was clear that significantly increasing taxation of the hydrocarbons sector—if not more fundamental reforms to state-hydrocarbon company relationships as well—would be a prerequisite for social peace. While pressure from business in Santa Cruz and their political allies to avoid substantial changes was strong, the new government's fear of a popular uprising took precedence. As a former Hydrocarbons Minister recalled:

Habían dos posiciones extremas. Había la extrema de izquierda, que quería nacionalización, que quería que se les quite todo... la otra extrema quería que no se cambie nada. Nosotros estábamos en una posición intermedia de decir bueno, si en este país se ha generado un problema social, y nosotros no hacemos nada, ningún cambio, este problema va a continuar. Y en la medida en que estos [cambios] se vaya postergando, los problemas sociales van a ser mayores. Y va a ver un baño de sangre. Y lo que nosotros queríamos como gobierno de transición era evitar que haya ese baño de sangre. No queríamos más muertos. Ya habían habido sesenta muertos

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<sup>66</sup>On the details of the capitalization reforms, see for example Zaratti 2004.

<sup>67</sup>See also MAS 2005: 22-23.

<sup>68</sup>The 1996 reform included a surtax designed to tax windfall profits, which would take affect after companies had recovered their investments and in times of high production volumes and high international prices. However, the details of the surtax had never been formally established. Addressing this issue was one of the tax reforms on Sanchez de Lozada's agenda when he took office in 2002, but the administration quickly encountered severe political and social problems that prevented action on this front. In addition, disagreements within the administration hindered progress on the surtax. The administration did not present the surtax as a solution in response to popular pressure in Oct. 2003, probably in part because the reform was technically complicated and would have been difficult to explain, particularly given widespread rejection of Sanchez de Lozada's government and economic policies. Ironically, however, implementing the surtax contained in the 1996 hydrocarbons law may eventually have produced as much additional revenue for the state as the 2005 reform in combination with Morales' subsequent alterations to the hydrocarbon companies contracts (F. Cossio 2006, author's interview).

con el anterior gobierno... teníamos que buscar soluciones. (G. Torres 2006, author's interview).

Throughout the next year, pressure from MAS and mobilized popular sectors drove first the executive branch, and then congress, to accept reforms imposing increasingly harsher terms on the hydrocarbons companies. The executive's first reform proposal, drafted in April 2004, was a compromise position that it hoped would satisfy MAS and the mobilized popular sectors without causing investment to plummet or violating contracts, which the administration feared would provoke the hydrocarbons companies to seek international arbitration (author's interviews: Mesa 2006, Jemio 2006, X. Nogales 2007). Accordingly, the government negotiated the terms of the proposal directly with the hydrocarbons companies. On the one hand, the proposal included substantial tax increases for the most profitable hydrocarbons fields, a measure that the companies reluctantly accepted given the events of October 2003. As former Hydrocarbons Minister Nogales recalled, he informed the companies that "la gente quiere sangre, tanta sangre como puedo [sacar], pero no te voy a matar," (X. Nogales 2007, author's interview). On the other hand, the proposal maintained incentives for exploration and investment, tax increases would be phased in gradually, and lower tax rates would apply to smaller, less profitable operations. The hydrocarbons companies viewed this compromise quite favorably (Kieffer 2007, author's interview).

However, MAS's political strength, predicated on mobilizational capacity, compelled President Mesa to include more radical measures in the July 2004 gas referendum questions. In order to secure Morales' endorsement of the referendum (X Nogales 2007, author's interview), Mesa included the following as Question 2: "¿Está usted de acuerdo con la recuperación de la propiedad de todos los hidrocarburos en boca de pozo para el Estado?"<sup>69</sup> This question, which implied nationalization, helped ensure that MAS would not boycott the referendum, a move that would have undermined Mesa's legitimacy, his ability to carry out reform, and his capacity to maintain order. The additional four referendum questions were ambiguously worded in an effort to obtain the highest levels of popular support possible (X Nogales 2007, author's interview). Question 5, which included the issue of taxation, was not only ambiguously worded, but also patently multi-barreled:

¿Está usted de acuerdo con que Bolivia exporte gas en el marco de una política nacional que: Cubra el consumo de gas de las bolivianas y bolivianos, fomente la industrialización del gas en territorio nacional, cobre impuestos y/o regalías a las empresas petroleras llegando al 50% del valor de la producción del gas y el petróleo en favor del país, destine los recursos de la exportación e industrialización del gas principalmente para educación, salud, caminos y empleos?<sup>70</sup>

All of the referendum questions were approved with high levels of support (72% of valid votes in favor for question 2 and 62% for question 5).<sup>71</sup> But while the referendum strengthened Mesa in the short-term (Lazarte 2005: 587), the design of the questions created political opportunities later on for those who favored more radical changes to the hydrocarbons law. Question 2 set a precedent for altering the companies' contracts much more fundamentally than Hydrocarbons Minister Nogales thought appropriate; this question provoked his resignation (X Nogales 2007, author's interview).<sup>72</sup> Mesa himself had no intention of nationalizing the sector; instead, he feared that violating the companies' contracts could lead to international lawsuits. Likewise, the ambiguous wording of the other questions created room for MAS to object to the executive's subsequent reform proposals in favor of more radical changes (Lazarte 2005: 587). For example, MAS maintained that Question 5 mandated congress to impose a uniform royalty of 50% on the hydrocarbons production, whereas the executive's intention was that the sum total of taxes on the sector would reach in some cases but never exceed 50%. As a Cámara de Hidrocarburos informant recalled, the referendum was a key turning point in the reform process that led

<sup>69</sup>Decreto Supremo 27507, Carlos Mesa.

<sup>70</sup>Decreto Supremo 27507, Carlos Mesa.

<sup>71</sup>However, 23% of referendum ballots were blank or null for question 2 and 29% for question 5 (Corte Nacional Electoral, [www.cne.org.bo](http://www.cne.org.bo)).

<sup>72</sup>X. Nogales (2007, author's interview) objected that the state had never possessed ownership of oil in the well-head; once oil left the ground, it was considered production.

to an outcome far less favorable for the companies than the April draft proposal (Kieffer 2007, author's interview).

The executive quickly lost control over the reform process after the referendum, given President Mesa's weak relationship with congress, and pressure from MAS coupled with fear of popular mobilization led the legislators to endorse the more radical interpretations of the reforms suggested in the referendum questions. MAS's influence on the design of the reform outweighed the size of its relatively small block in congress, thanks to its mobilizational capacity. As a former president of the Comisión de Hacienda in the Cámara de Diputados recalled of MAS:

Lo que ellos tenían era una enorme capacidad de participar en los debates. ...sobre todo tenían una gran capacidad de coordinar presión al parlamento con las organizaciones sociales. Afuera en la calle. Grandes marchas, grandes movilizaciones. ... obviamente el parlamento estaba acostumbrado a ceder a esas presiones. Es que era muy fuerte. (J. Torres 2007, author's interview)

In this context, the executive's proposal, which increased taxes gradually according to specified production and other criteria, was not politically viable and encountered generalized rejection: "La propuesta del Presidente Mesa cumplía con el referéndum por que llegaba a 50%, pero en realidad, podías llegar en el año 3000—a muy largo plazo, con grandes niveles de producción. En este sentido, era una propuesta mentirosa," (J. Torres 2007, author's interview). Although controversy arose over the details of designing the new tax, popular mobilization helped forge consensus in congress in favor of a flat, up-front rate of 50%. In the words of a former MAS deputy: "ya la gente en la calle que estaba obligando a eso. ... no hubo oposición [en el parlamento]. Ya había un pueblo de pie." (Torrice 2007, author's interview). Even the traditional parties felt compelled to opt for a single rate of 50% and to oblige the companies to renegotiated their contracts on terms more favorable to the state. As the former senate president Vaca Diez (2007, author's interview) recalled:

Finalmente por razones políticas, la propia bancada del MNR asumió una actitud política de decir bueno: este dijo en el referéndum que 50%, entonces 50%. Que recuperación de la propiedad: recuperemos la propiedad en boca de poza. Toda la fuerza de los que gobernaron con Goni cayeron con Goni.

However, the traditional parties did manage to defeat MAS's initiative to create a new royalty of 32% (which in combination with the existing 18% royalty would reach 50%). This proposal was problematic because altering royalties would directly violate the terms of the hydrocarbon companies' contracts. In addition, according to international standards, companies cannot credit royalties against tax obligations in their home countries. Instead of a royalty, congress created a new tax of 32% on the value of production, the "direct tax on hydrocarbons" (Impuesto Directo a los Hidrocarburos), which did not entail violating contracts (Jemio 2006, author's interview). Further, the Bolivian state would collect the same amount of revenue, but the hydrocarbon companies would receive tax credits in their home countries.

Given the strength of popular mobilization and widespread demands for higher taxation of hydrocarbons, it is not surprising that business achieved little influence in congress. The reform ultimately passed with votes from the traditional parties; MAS opposed the final legislation, largely for strategic reasons. Remarkably, MNR and MIR representatives from Santa Cruz did not close ranks with business against the hydrocarbons reform (Soruco 2007, author's interview), in stark contrast to the open coordination between legislators and peak associations from this department against the assets tax in 2004. In fact, supporters of the dramatic tax increase on the hydrocarbons sector included legislators with informal ties to business in Santa Cruz. For example, former MIR deputy Soruco, who had worked closely with the Santa Cruz peak associations against assets tax in 2004, lauded the reform as major accomplishment: "En el discurso de despedida que yo hizo de la presidencia de la Cámara de Diputados, yo la agradecía al MAS por su tozudez, por su terquedad en insistir. Porque gracias a esa terquedad ...se logró algo muy importante para Bolivia," (Soruco 2007, author's interview). Ironically, senate president Vaca Diez, himself a wealthy agricultural businessman from Santa Cruz who might have opposed the reform under other circumstances, was ultimately charged with promulgating the new hydrocarbons law

in the midst of strident objections from the Santa Cruz peak associations,<sup>73</sup> thanks to President Mesa's decision to neither promulgate nor veto the legislation.<sup>74</sup>

The breach between traditional party representatives and business associations in Santa Cruz can be explained by widespread popular approval of the reform within the department as well as advantageous revenue-sharing measures included in the legislation. Although the threat of popular mobilization in demand of nationalization was stronger in the western departments, higher taxation of hydrocarbons was tremendously popular even among voters in Santa Cruz—88% of valid referendum votes in Santa Cruz even supported Question 2 on recovering state property of hydrocarbons at the well-head, compared to a slightly higher 93% in La Paz.<sup>75</sup> On the one hand, the reform appealed to nationalistic sentiments; on the other hand, the new tax applied only to multinational companies and imposed no direct burden on Bolivian voters, in contrast to the assets tax. Legislators from Santa Cruz had additional incentives to support the reform given that four percentage points of the new tax created in congress were earmarked for each hydrocarbon-producing department. Their constituencies would benefit greatly from the massive influx of revenue to the departmental and municipal governments.

### **Comparison with Chile: Taxing the Copper Sector**

Differences in levels of popular mobilization and the nature of popular demands explain in large part why Chile's tax increase on copper was so marginal compared to Bolivia's tax increase on hydrocarbons. Taxing the privately-owned copper sector in Chile was extremely popular, as was taxing hydrocarbons in Bolivia, given similar nationalistic sentiments that natural resources belonged to the state and similar outrage at the low taxes paid by multinational firms. But in Chile, popular mobilization simply was not an issue; popular sectors did not mobilize to demand reform, nor was there any potential for popular protest if reform were to be rejected in congress. Popular sectors simply were not political actors in the politics of tax reform, aside from their role as voters who could potentially punish politicians at the polls. Further, under the prevailing conditions of normal democratic politics, many strategies were available for politicians who opposed taxing the copper sector to avoid punishment at the polls. In contrast, popular sectors in Bolivia were central political actors thanks to their mobilizational capacity, and they advanced radical demands—not just higher taxation of hydrocarbons, but nationalization. Faced with a potential social uprising that could overthrow the existing political order, politicians in Bolivia were forced to concede to many of the popular sectors' demands, including a major tax increase on hydrocarbons companies.

Although popular mobilization is the most important factor for understanding the different extractive sector tax outcomes in the two countries, business's stronger instrumental power also contributed to Chile's far more moderate tax increase. The copper sector benefited from the business's partisan linkages to right parties in Chile, a more reliable source of instrumental power than informal ties to non-programmatic parties in Bolivia. Business cohesion was also stronger in Chile than in Bolivia. Not only were regional cleavages absent in Chile, but the copper sector enjoyed stronger organizational linkages to the domestic peak associations, thanks in part to domestic ownership in the mining sector; in contrast, Bolivia's hydrocarbons sector was overwhelmingly composed of foreign and multinational companies. In addition, tax invariability clauses augmented the multinational copper companies' instrumental power in Chile. Altering royalties was problematic in both countries, but whereas this issue was easily circumvented in Bolivia by creating a new tax, in Chile, Decree Law 600 shielded the multinational copper companies from tax increases for a period of twenty years. The executive was therefore obliged to negotiate incentives directly with the companies in exchange for their agreement to voluntarily pay the new tax (Chapter 4 Part 3).

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<sup>73</sup>*El Deber*, May 6, 2005: "Aprueban la Ley del Gas."

<sup>74</sup>On the one hand, Mesa feared the legislation would provoke disinvestment and international lawsuits, while on the other hand, striking down the reform would almost certainly provoke popular protest.

<sup>75</sup>Corte Nacional Electoral. [www.cne.org.bo](http://www.cne.org.bo)

### **Comparison with Argentina: The Limited Role of Popular Mobilization in Tax Politics**

Popular mobilization on a few occasions played similar roles in Argentina as in Bolivia. However, this factor was less salient to the politics of taxing economic elites in Argentina, largely because of the fundamentally different nature of popular mobilization in the two countries. In Argentina, mobilized sectors tended to focus on narrow economic self-interests, whereas mobilization in Bolivia portended a threat of far-reaching social upheaval and radical socio-political change. Two policy areas in Argentina illustrate these comparisons: export taxes and individual income taxes.

In the case of export taxes, popular mobilization did not play as important a role in influencing the government's agenda or policy outcomes as in Bolivia with regard to an analogous policy area—hydrocarbons taxation. Massive and frequent protests by unemployed workers' organizations demanding expanded social programs in Argentina from 2000-2003 (Garay 2007) contributed to the state's revenue needs in the aftermath of the 2001 crisis, but they exerted little discernable influence over governments' tax reform agendas. The organizations demanded expanded benefits for unemployed workers that required financing, but the state faced dire revenue needs for other reasons as well. Export taxes were chosen as the main revenue-raising tool after 2001 primarily due to the producers' weak power, as well as technical considerations. Popular sectors did not demand taxation of agricultural exports during this period. In contrast, popular sector demands in Bolivia explicitly included higher taxation of the hydrocarbons sector, a reform that President Mesa may otherwise have sought to avoid given stronger business power.<sup>76</sup> Regarding reform outcomes, significant export tax increases in Argentina succeeded due to the producers' weak power alone, whereas a significant hydrocarbon royalty increase was legislated in Bolivia due to pressure from highly mobilized popular sectors, which overwhelmed business power. Unemployed workers' organizations in Argentina did mobilize in favor of export taxes during 2008, once the conflict with the producers had begun, in order to support a government that had successfully incorporated them into its political base (Etchemendy and Garay forthcoming). These demonstrations, joined by other pro-government sectors including labor unions and human rights groups, counterbalanced protests by anti-government sectors in Buenos Aires and bolstered the government's position. Overall, however, they played a secondary role in the export tax conflict. It was the producers who mounted massive and sustained mobilization; sporadic demonstrations by government supporters were no match for the producers' protracted capital strikes. In Bolivia, in contrast, it was widespread popular sector mobilization that posed the major threat not only to the incumbent government, but also to the existing political regime and exclusionary social order more generally. Indeed, the demand for higher taxation of the hydrocarbon sector was a key ideological element of the challenge to the prevailing political and economic systems. Under these circumstances, popular mobilization in Bolivia more effectively counterbalanced business power.

Turning to the second policy area, both Argentina and Bolivia experienced protests against individual income taxes. However, whereas the consequences for taxation of economic elites were profound in Bolivia, they were relatively insignificant in Argentina. In 2006, Argentine oil workers staged multiple strikes demanding reduced income taxation with support from the national labor confederation, the CGT.<sup>77</sup> The 2006 strikes, along with pressure from the CGT, compelled the government to grant various concessions, including higher income tax deductions for wage-earners in March 2006 and particularistic income tax exemptions for oil workers in November 2006.<sup>78</sup> These concessions benefited relatively privileged sectors of society—the top 10% of formal sector workers with

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<sup>76</sup>Mesa (2006: author's interview) declined to promulgate the new law approved in Congress, which increased hydrocarbon taxation more than the executive had proposed, in part due to concerns regarding the sector's structural power: "en ese momento lo creía, se podía poner en riesgo las inversiones y la relación de Bolivia con el mundo inversionista extranjero con esa ley."

<sup>77</sup>These mobilizations were part of a broader campaign by organized labor in pursuit of higher wages and other economic demands. Labor unions experienced a resurgence in Argentina in the 2000s and sustained high levels of mobilization in 2005 and 2006. See Etchemendy and Collier (2007: 370-2).

<sup>78</sup>The government increased deductions again in 2007, a move that was interpreted in the press as a bid to win electoral support from urban middle sectors.

the highest wages.<sup>79</sup> These workers were far better-off than the majority of citizens, who did not earn enough to pay income taxes in the first place. However, these concessions did not substantially alter the tax burden imposed on individuals in the highest-income brackets.<sup>80</sup> In contrast, the 2003 income tax protest in Bolivia forced the government to revoke a major policy initiative that would have taxed the income of the wealthiest individuals in Bolivia for the first time since 1985. The failure to create a progressive income tax in Bolivia cost the state an estimated 1.5% GDP per year in forgone revenue; the income tax concessions in Argentina cost less than 0.3% GDP per year.<sup>81</sup> Further, the 2006 income tax protests in Argentina had little impact on the political dynamics of taxing economic elites. In Bolivia, in contrast, the 2003 protest created a lasting legacy that undermines prospects for taxing upper-income individuals; policymakers fear renewed protest in response to reintroduction of an income tax proposal, even if narrowly targeted at elites. This difference is again related in part to the very different nature of popular mobilization in Bolivia compared to Argentina. Although protests in both countries included sectors concerned primarily with their own economic interests, the Bolivian protest embodied a much more expansive, anti-government, and transformative agenda, and it formed part of a larger cycle of mobilization that ultimately forced President Sanchez de Lozada to leave office. The income tax in Bolivia lacks legitimacy in the eyes of the populace due to its association with Sanchez de Lozada, who is popularly viewed as morally repugnant, and with the IMF, which embodies an economic model condemned as unjust and ineffectual. In Argentina, in contrast, the progressive income tax remains a legitimate redistributive tool.

#### **Tax Policy During the Morales Administration**

After assuming the presidency in 2006, Morales undertook additional measures to increase taxation of the hydrocarbons sector, in accord with MAS's campaign promises. Morales issued a decree increasing royalties for the companies operating Bolivia's two largest gas fields to 82% and "nationalizing" the hydrocarbons sector in May 2006 amidst widespread popular approval, even from within the *media-luna* departments that generally opposed MAS's economic policies (Gamarra 2008: 129). Technically, the policies enacted did not constitute nationalization; the contracts were simply renegotiated on terms more favorable to the state.<sup>82</sup> The hydrocarbons companies with established operations accepted the new contracts, in part because they contained a number of potentially highly advantageous clauses for the multinationals, including investment incentives and the possibility of recovering costs of exploration (author's interviews: Zarrati 2006, G. Torres 2006).<sup>83</sup> Two years later, however, new investment was at a "standstill," due in part to continued contract negotiations with the

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<sup>79</sup>*Clarín*, March 16, 2006: "Aumentan el mínimo no imponible en Ganancias," by Martín Kanenguiser.

<sup>80</sup>In 1999, the De la Rúa administration passed a progressive income tax reform that limited the percentage of the basic deductions that could be used by taxpayers in upper-income brackets. The percentage of permitted deductions decreased gradually to zero for taxpayers in the top income tax bracket. While all taxpayers except those in the top bracket benefited from the increased deductions, the impact on higher income earners was therefore limited. In December 2008, however, the government eliminated this aspect of the 1999 reform, given persistent objections that the so-called "tablita de deducciones" created distortions; passing to a higher bracket could create a disproportionate increase in the taxpayer's income tax burden (MECON B 2006: author's interview). This reform also responded to demands from the CGT, since along with high-income earners, the reform would also benefit the highest-paid formal sector workers. However, the fiscal cost of this measure was also moderate—1510 million pesos. *Clarín*, Dec. 13, 2008: "El Plan Anticrisis: Luz Verde a un Reclamo Histórico de la CGT."

<sup>81</sup>The most significant of the concessions, raising the income tax deductions, cost an estimated 1500 million pesos per year (0.23% GDP) (*Clarín*, March 6, 2006: "Aumentan el mínimo no imponible en Ganancias"). The government expected to receive an additional 300 million pesos in VAT revenue thanks to increased consumption, which would reduce the net cost to 0.18% GDP.

<sup>82</sup>All non-MAS informants confirmed this point; the state simply renegotiated contracts with the companies (see for example Matkovic 2006, Mesa 2006, J. Torres 2007, Hydrocarbons Sector A 2007).

<sup>83</sup>In addition, it was unclear at the end of 2006 as to whether or not Morales' tax increase would in practice constitute an additional tax burden or simply an advancement of multinationals' tax payments, given lack of clarity in the wording of the contracts (Zaratti 2006, author's interview). Some informants felt that the new contracts were not as bad for the private companies as anticipated (Hydrocarbons Sector A 2007), although an informant from Petrobras (Hydrocarbons Sector D 2007) asserted that its new contract was certainly much less favorable than the former contract.



state (EUI 2008). Structural power in this case did not compel the government to reverse its policies, but may instead have encouraged the government to pursue more radical reforms in the form of an even greater role for the state in the hydrocarbons sector: in May of 2008, the government forcibly acquired majority shares in the three major companies (Chaco, Andina, and Transredes, the pipeline operator).

In contrast to hydrocarbons, taxes on income and wealth remained off of the agenda, despite the fact that one might expect a left government with a state-centric development agenda to promote progressive taxation as a redistributive tool. On the one hand, the individual income tax remained highly unpopular due to association with Sanchez de Lozada and the IMF, as discussed above. On the other hand, taxing hydrocarbons multinationals, which was extremely popular, served as a clear and politically logical alternative to taxing Bolivian individuals. In the words of MAS senator Santos Ramírez (2007, author's interview): "Nuestro gobierno no ha visto para nada mayores impuestos ni al salario ni al patrimonio de los Bolivianos. Estamos en una nueva visión que los mayores y mejores ingresos que se pueda generar necesariamente tiene que venir de los recursos naturales."<sup>84</sup>

Further, higher taxes on the hydrocarbons sector, in combination with booming international prices, alleviated Bolivia's revenue needs. Total tax revenue averaged 13.8% of GDP from 2000 to 2004; tax revenue increased to an average of 22.7% of GDP from 2006 to 2008. Taxes on hydrocarbons, most importantly, the "direct tax" legislated in 2005, accounted for fully 8% GDP on average from 2006 to 2008.<sup>85</sup> This revenue dwarfed the 1-2% GDP that previous governments had attempted to raise through taxes on individual income and wealth. Thanks in large part to the hydrocarbons tax, Bolivia achieved an unprecedented fiscal surplus of 4.6% of GDP in 2006 (EIU 2008). As in Chile after 2005, a context of relative abundance reduced government incentives for considering domestic tax increases, although a few such initiatives were undertaken early in Morales' presidency.<sup>86</sup> Instead, the government had strong incentives to reconsider the rules governing allocation of hydrocarbons revenue between the national government and the departmental governments, a major point of contention with the *media luna*. On the one hand, the government wished to cap the amount of hydrocarbon tax revenue transferred to subnational governments (Torrico 2007, author's interview); the 2005 hydrocarbons law earmarked large percentages of the new tax to departmental and municipal governments, as well as public universities and other entities, which left a relatively small share for the national treasury. On the other hand, *media luna* departments sought to retain a larger share of all tax revenue generated in their departments.<sup>87</sup>

Finally, Morales prioritized more visible redistributive policies and a broader transformative agenda. Foremost among these redistributive policies has been land reform, which entails the tangible transfer of a physical asset from the "oligarchy" to poor, landless peasants, who have often organized to demand and seize land. Land reform can generate much more support for the government among popular sectors than progressive taxation, which entails a multistage and much less visible transfer of resources from rich to poor. Tax payments made by economic elites cannot be as directly observed, and the connection between taxation and benefits for popular sectors that they may finance is not always obvious, although earmarking and other linkage techniques can make the connection more apparent.<sup>88</sup>

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<sup>84</sup>Interestingly, however, MAS's campaign platform did mention the possibility of creating an individual income tax (MAS 2005: 92).

<sup>85</sup>Author's calculations based on SIN data ([www.impuestos.gov.bo](http://www.impuestos.gov.bo)).

<sup>86</sup>For example, the government renewed the financial transactions tax and eliminated a much-abused simplified tax regime for inter-departmental transport (author's interviews: J. Nogales 2007, VMPT A 2006). The government also proposed a tax increase on the mining sector in a context of increasing mineral prices. This initiative met with protest from members of mining cooperatives, who marched on La Paz early in 2007 (VMPT A 2007, author's interview). The government subsequently directed its efforts toward nationalization; the Vinto smelting company was taken over by the state in February 2007 (Gamarra 2008: 136).

<sup>87</sup>See Eaton (2007) on the fiscal component of Santa Cruz's autonomy demands. See also PODEMOS 2005: 52.

<sup>88</sup>Sanchez de Lozada's former finance minister offered this perspective regarding confiscation versus taxation: "Decir: vamos a expropiar las viviendas de las personas que tienen mas de una vivienda—eso es popular—ese rico que tiene mas de una vivienda, para que necesita tantas? Yo creo que el gobierno está consiente de esto. Si va a querer hacer medidas populares, es preferible ir por este lado. --Expropiar es más visible? Claro. Exactamente. La gente lo ve, y lo cree. En cambio decir vamos a cobrar un impuesto a los ricos, que con la plata que recojamos de los ricos lo vamos a dar a los pobres, sí, pero es mas directo decir: les

Morales' broader transformative agenda entailed constitutional reform, with the stated goal of breaking with the country's history of social, economic and political exclusion of indigenous peoples and to re-found Bolivia as a multicultural nation (Gamarra 2008: 138). Designing and implementing constitutional reform absorbed much of the government's attention from 2006 to 2009 and required a major expenditure of political capital, given virulent resistance from the opposition parties and the *media luna* departments.

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vamos a quitar. Eso vende mas. Ellos tiene mucho, y tienen esto de haber robado a los pobres—eso es un discurso que vende, que la gente acepta más,” (Comboni 2007, author's interview).

## Chapter 8: Conclusion

### Overview

This study has examined the problem of revenue-raising tax reform in Latin America, a region characterized by weak tax capacity and extreme inequality, through comparative analysis of tax agendas and the outcomes of reform proposals in Chile, Argentina, and Bolivia. These countries experienced growing revenue needs in the aftermath of market-oriented “first-generation” tax reforms in the 1980s and early 1990s. Yet while Argentina made significant progress in a number of tax policy areas, including second-generation reforms that targeted elite resources, tax increases in Chile were marginal. In Bolivia, meanwhile, efforts to increase taxation of domestic elites were largely unsuccessful. I have explained these cross-national outcomes, as well as variation within countries across tax policy areas and over time, by analyzing business power and government reform strategies.

Business power creates overarching constraints on tax reform. Business can exert influence through two broad, conceptually distinct means: instrumental power and structural power. Instrumental power entails deliberate actions to influence policy in the political arena. Sources of instrumental power include relationships between business and decision-makers that provide access and may create bias in favor of business interests, and resources that help business pressure policymakers more effectively. Structural power arises from a perceived disinvestment threat—a threat that a reform will provoke reduced investment, or other undesirable economic outcomes. Structural power requires no organization or political action; instead, market signals coordinate investors in the economic arena. Both instrumental power and structural power vary across countries and over time. Instrumental power can also vary across sectors, while structural power varies across policy areas. When either instrumental power or structural power is strong, taxing elites will likely be a difficult challenge.

However, governments can employ tax-side and/or benefit-side strategies to circumvent obstacles created by business power. Tax-side strategies (legitimizing appeals, obfuscating incidence and attenuating impact) exploit characteristics of the tax tool in question. Benefit-side strategies (compensation, linking to social spending, and emphasizing stabilization) aim to shift attention away from the immediate costs of the tax increase by forging links to benefits associated with the tax reform. These strategies may reduce business opposition to reform, they may counter-balance business pressure on politicians by generating public support for reform, and/or they may reduce concern regarding the impact of reform on investment. Strategies are often closely associated with tax policy choice or the design of a broader reform package. Although government reform strategies are important, strategy choice tends to be secondary to business power for understanding the extent to which it is possible to tax economic elites.

In Chile, I have argued that business’s strong instrumental power kept all but marginal tax reforms off the executive’s agenda after the democratic transition, even in the absence of structural power. Business enjoyed three highly institutionalized sources of instrumental power: cross-sectoral business cohesion arising from strong cross-sectoral organization and shared anti-statist ideology; partisan linkages between business and the two right-wing opposition parties, which enjoyed consistently strong representation in congress; and informally institutionalized bipartite government-business consultation (concertation) on economic policy. Cohesion allowed business to effectively mobilize against tax increases, links to right parties helped business block reforms in congress, and government-business concertation created incentives for the executive branch to avoid conflict over taxation, a core business interest in Chile. Although the governing Concertación coalition developed a wide repertoire of tax-side and benefit-side strategies during its long tenure in power that made some marginal tax increases possible, tax revenue in Chile remained essentially constant until 2005, when soaring international copper prices swelled the tax base.

Business power in Argentina tended to be much weaker than in Chile. Business lacked instrumental power at the cross-sectoral level, due to fragmentation and the absence of an electorally-relevant traditional right party capable of defending elite interests in congress. Therefore, Argentine governments were able to make more progress at increasing corporate taxation, a policy area with cross-

sectoral impact. Argentine governments were also able to pass major revenue-raising reforms in policy areas of sector-specific concern. For example, the tax agency obtained strong auditing powers in the form of extensive access to bank information, which is often a sensitive issue for the financial sector, and governments applied high taxes on agricultural exports following the 2001 crisis, which placed a heavy burden on producers. However, finance and agriculture did enjoy substantial power during delimited time-periods. For example, structural power arising from concerns that investors would withdraw their money from the banks, coupled with instrumental power based on the financial sector's recruitment into government and informal ties to the executive branch, kept expanding tax agency access to bank information off the agenda during the 1990s. Instrumental power arising from informal ties to a cabinet member helped agricultural producers prevent a reduction in the VAT rates on grains. And instrumental power based on increased cohesion, thanks to the formation of an encompassing organization, helped the producers sustain massive protests, in the form of capital strikes, that forced the government to reverse a major 2008 agricultural export tax increase.

Business power in Bolivia from 2003-2005, when second-generation tax reforms entered the national agenda, was intermediate compared to Chile and Argentina. Business cohesion was weaker than in Chile due to a regional division, but stronger than in Argentina thanks to the presence of strong encompassing organizations and a common "formal sector" identity. Likewise, business's relationships with legislators were weaker than in Chile due to the absence of partisan linkages, but informal ties to legislators during the period analyzed were a more effective source of instrumental power than in Argentina, due to much weaker executive authority over the governing coalition. In addition, high levels of popular mobilization that threatened radical socioeconomic change, a factor that was not relevant to tax politics in Chile or Argentina, counterbalanced business power. The potential for mass demonstrations against broad-based tax increases compelled policymakers to propose tax increases that targeted economic elites. Business was therefore unable to keep reforms it opposed off the agenda. Business associations had to expend energy and resources to defeat the 2004 assets tax proposal. And popular mobilization to demand higher taxation of foreign and multinational hydrocarbons companies forced this issue onto the agenda and overwhelmed business power, contributing to much larger tax increases on natural resource extraction than in Chile.

### **Findings, Contributions, and Implications**

This research has aimed to address two lacuna in the political science literature on Latin America. First is the surprising lack of attention to taxation, which is critical for maintaining fiscal discipline and economic stability, financing social spending, and supporting essentially all state functions, precluding dependence on foreign aid or resource rents. Second is the relative neglect of business politics, as noted by Schneider (2004: xxi), despite the fact that "freer markets and politics have granted business an ever more central role in the political economy of Latin America." The remainder of this chapter delineates the main findings, contributions, and implications of this research regarding taxation, business politics, and redistribution.

### ***New Perspectives on Taxation in Chile and Argentina***

This research provides new perspectives on taxation in Chile and Argentina. Widely cited research on taxation in Chile characterizes the country as a success story for raising revenue and enhancing progressivity, based on the 1990 corporate tax increase (Weyland 1997). Yet increasing the still very low corporate tax remains among the most important reforms needed to improve tax equity and tax capacity in Chile. Further, inadequate bank information access handicaps the tax agency's ability to control income tax evasion. Argentina has been characterized as a case of persistently weak tax capacity (Melo 2007, Bergman 2003). Yet corporate tax revenue growth since 1992 demonstrates that Argentina has developed notable extractive capacity in this tax policy area over time. Further, Argentina's tax agency is now more powerful than its internationally acclaimed Chilean counterpart, and even many tax agencies in developed countries, in the area of bank information access. Argentina's tax agency is also more powerful than Chile's in terms of regulating transfer pricing and controlling sophisticated forms of VAT evasion. These

outcomes run counter to longstanding views that state capacity is much stronger in Chile than in Argentina. In a number of regards, the reverse was actually true as of the mid to late 2000s in the realm of taxation.

### ***Business as a Critical But Neglected Actor in Tax Politics***

The role of business is often ignored in literature on taxation and state capacity and in analyses produced by international financial institutions. Yet business, whether organized or in the form of individual firms and investors, is a key actor in tax politics. Many taxes directly or indirectly affect profits and therefore tend to elicit business opposition. And like right parties, business associations may defend the interests of upper-income individuals, as well as corporations. My research suggests that in extremely unequal societies, when business is highly cohesive, due to strong encompassing organization, shared ideology, and/or a common identity defined with respect to other social groups, business associations sometimes play an active role in the politics surrounding taxation of individual income and wealth, as well as taxation that more directly affects businesses, as occurred in both Chile and Bolivia. In contrast, in Argentina where business cohesion was weak, business associations lobbied less actively, if at all, against proposed tax increases on individual income or wealth.<sup>1</sup>

Of course, other societal actors, including organized popular sectors and/or labor unions, may also play a role in tax politics. But with a few important Bolivian exceptions (including the 2003 income tax proposal and taxation of the hydrocarbons sector) these actors did not mobilize with respect to elite-targeted taxes. Instead, they defended the perceived direct interests of their own sectors. The ability of labor and/or popular sectors to mobilize and/or their importance as political constituencies may counterbalance business power by eliminating broad-based alternatives to elite-targeted taxes from the set of feasible revenue-raising options. But the fate of proposed tax increases that targeted elites depended more often than not on business power.

Factors other than business power can also create obstacles to second-generation tax reform. For example, partisan politics in congress can hinder reform even when business relationships with legislators are weak. In Argentina, the major opposition party occasionally obstructed government tax legislation for political reasons, even if the substance of the proposal was generally congruent with the party's policy preferences.<sup>2</sup> And in Bolivia, MAS's electoral ambitions and need to differentiate itself from the Mesa administration contributed to the party's lack of support for the executive's elite-targeted tax reform proposal, which was otherwise consistent with MAS's redistributive agenda. But examining business power is nevertheless a critical first step toward assessing prospects for revenue-raising tax reform.

### ***The Value of the Classic Business Power Framework for Causal Analysis***

Contemporary studies of business politics often lack clear causal frameworks for explaining when business does and does not achieve influence. Hacker and Pierson (2002) have diagnosed this problem with respect to literature on welfare state development in the United States. They point to authors' lack of attention to multiple mechanisms of business influence, misspecification of preferences, and the tendency to attribute convergence of business preferences and policy outcomes to business influence without carefully establishing causality. Research on business in other regions suffers from similar problems. For example, Handley's (2008) work on business in Africa fails to systematically assess or explain business influence. Sections in four country case chapters purportedly address why business won or failed to win demands regarding various aspects of economic policy; however, Handley often simply

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<sup>1</sup>In 1999, for example, business voiced little opposition to a reform that would increase individual income and assets taxes. While one UIA representative did complain that personal income tax increases would suppress demand and deepen the recession (*Clarín*, Dec. 21, 1999: "La Economía que Viene"), a member of the Consejo Empresario Argentino expressed open support for shifting the tax burden from business to individuals (*Clarín*, Dec. 5, 1999: "Enrique Ruete Aguirre, Presidente del Grupo HSBC").

<sup>2</sup>For example, the Peronists opposed an anti-evasion reform package initiated by the Radical administration in 2000 for partisan reasons, despite the existence of a broad consensus in favor of strengthening the tax agency and fighting evasion (Baglini 2006, author's interview).

describes the nature of government-business relations on the one hand, and economic policy outcomes on the other hand, with very little analysis connecting causal factors to outcomes.<sup>3</sup> Further, Handley does not specify what makes business “strong” or “powerful,” beyond the size and “autonomy” of the private sector with respect to the state and “organizational effectiveness.”<sup>4</sup> Size and autonomy of the private sector on their own are poor indicators of business power, and organizational effectiveness is conflated with outcomes. Her analysis of business influence therefore appears post-hoc. Similarly, Gallo’s (2008) work on taxation of nitrates in Chile describes power relations between producers and the state on the one hand and bargaining outcomes on the other hand with little systematic discussion of what made producers better able to secure concessions from the government in some periods compared to others. While Gallo notes the importance of nitrate producers’ “political resources” in her framework, this concept is underspecified and is not systematically scored in her empirical cases.<sup>5</sup>

As Hacker and Pierson (2002) advocate, the classic instrumental and structural power framework can form the basis for a more convincing analysis of business influence. The business power framework as elaborated in Chapter 2 complements and advances theories that focus on societal actors’ “bargaining power.” Levi (1988) employs bargaining power as one of her key causal factors for explaining the origins and structure of revenue systems. She attributes societal actors’ bargaining power to coercive, economic, and political resources. Yet she discusses these resources at a very general level, without delineating a concrete set of factors to be observed across cases. As Lieberman (2003: 25) observes: “A better specified model would incorporate the prior factors that affect the bargaining power of actors... Without such additions, it becomes all too easy to make claims about the sources of these rather general analytical variables in a post hoc manner.” The sources of instrumental power and structural power classified in Chapter 2 address precisely this problem. The business power framework is not directly applicable to Levi’s case studies, which do not involve business as a central actor, in part because many are drawn from early periods of history. However, for tax reforms in modern times in which business is a key economic and/or political actor, the business power framework allows for the emphasis on strategic interactions between state and society advanced by Levi, while also identifying specific sources of power that strengthen business’s bargaining position and indicate how and when business is likely to exert influence.

### ***Insights Regarding Instrumental and Structural Power***

This research offers a number of insights regarding business power. In particular, the analysis highlights the importance of studying influence over the reform agenda. Business’s influence over the agenda can be much more important than influence during subsequent stages of policymaking, as illustrated by the case of corporate taxation in Chile. Focusing on more manifest aspects of business power, such as lobbying after bills have been drafted, without studying policymakers’ perceptions and actual preferences, may lead to underestimating business influence, a critical point previously made by Hacker and Pierson (2002).

Further, I find that instrumental power can be as, or more important than structural power for setting the agenda, a possibility that many authors do not explicitly consider.<sup>6</sup> Instrumental power does not come into play only after the executive has delineated the core features of a reform. Just as

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<sup>3</sup>These problems are particularly evident with her treatment of Mauritius and Ghana. In the latter case, she concedes: “There is no straightforward explanation for Ghana’s policy outcomes of the 1990s” (Handley 2008: 199). In South Africa, Handley (2008: 93-4) implicitly attributes business influence across policy areas to structural power, without providing any solid evidence to substantiate the claim. The discussion on Zambia includes two more convincing causal assessments: first, that business divisions weakened business influence, and second, that the prevalence of personalistic business-policymaker networks undermined organized business’s ability to advance sector-wide interests (Handley: 239). Both of these statements are consistent with the theory and case studies explicated in my research.

<sup>4</sup>See for example Handley (2008: 10-12, 93-94). For the South African case, Handley (2008: 93) asserts that “business won most of what it sought” thanks to autonomy from the state, and “strength,” understood as “the dominance of big business” within the private sector. Her indicators are not systematically scored across the other country cases.

<sup>5</sup>A second variable Gallo emphasizes, mobility of the taxed resources, is essentially constant (low) across her analysis. And her third main causal factor, revenue stability, in my view affects business preferences more than business’s ability to exert influence.

<sup>6</sup>See for example Smith (2000: 115-141), Hacker and Pierson (2002: 279-286), Fuchs (2007: 56-58, 71-95).

policymakers may rule out reforms because they anticipate reduced investment, they may rule out reforms because they anticipate political resistance from business and business allies. This scenario may be most relevant in stable political systems where business has strong and institutionalized sources of instrumental power, as in Chile, such that it is easy for policymakers to anticipate reactions to reform.

My findings question recent arguments that elite cohesion facilitates progressive taxation and redistribution more generally. Authors have argued that fragmentation discourages business from coordinating around shared interests such as fiscal stability, whereas business and economic elites more generally can agree to pay higher taxes for the sake of their shared long-term interests when they are cohesive (Weyland 1996, Lieberman 2003). However, tax increases were more extensive in Argentina, where business was fragmented, compared to Chile, where business was highly cohesive. Accordingly, I treat cohesion as a source of instrumental power that helps business block policies it opposes (or promote policies it favors) by legitimating business demands and improving business's bargaining position with respect to the executive and/or legislative branch.

Turning to structural power, careful attention must be paid to policymakers' perceptions regarding anticipated consequences of reform. Policymakers' assessments of whether or not a reform is likely to hinder investment or provoke disinvestment may depend on multiple factors that vary across countries, over time, and across policy areas. On the one hand, different reforms may affect, or convey different signals to, investors with different types of assets. On the other hand, similar reforms may create different incentives for investors in different contexts. Further, while capital mobility or the mobility of taxable resources more generally can be a key component of structural power, it does not ensure a credible disinvestment threat. Cases examined in previous chapters where structural power was weak despite high mobility include corporate taxation during substantial time-periods in both Chile and Argentina, export taxes in Argentina from 2002 through 2008, and tax agency access to bank information in Argentina after 2001. Investors or producers will relocate or shift to other types of production only if a reform significantly reduces profits relative to alternative investment options. Taxes are only one of many policies affecting profits, and favorable policies in other areas may offset the costs of higher taxation. Alternatively, high commodity prices may sustain profitability despite heavy taxation. Further, structural power is not necessarily a sector-level characteristic, as illustrated in Chapter 5. Instead, structural power may depend on the particular policy area in question, once again because different policies may create different incentives for investors or producers.

### ***Extending the Business Power Framework***

Applying the business power framework to countries and policy issues beyond those considered in this research could serve to identify additional sources of instrumental power and other arenas in which business may exercise instrumental power.

If the scope of analysis is extended to policy implementation and enforcement, favorable relationships with bureaucrats in state agencies may be an important source of business power. Business may enjoy informal ties to bureaucrats or even recruitment into state agencies, including the tax administration. Although business for the most part did not enjoy these sources of power in the countries and time periods I have examined, favorable business relationships with tax agency officials existed in the past and are pervasive in other regions. Professionalization of tax agencies remains a pending and imperative task in many developing countries. In these cases, favorable relationships with bureaucrats may not only help business stymie implementation and enforcement, but also allow business to indirectly influence policy decisions. If informal ties to tax agency officials are pervasive, policymakers may rule out elite-targeted reforms as unenforceable.

The judicial branch is another potentially important formal policymaking arena, although it was not relevant to tax reform in the cases included in this study.<sup>7</sup> To cite a single concrete example, the

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<sup>7</sup>See Kapiszewski and Taylor (2008: 743-44) for a review of literature addressing the courts as a policymaking arena in Latin America. Kapiszewski and Taylor (2008: 744) observe: "judges and policy-makers alike are aware that judicial decisions on cases regarding social and economic rights can have significant policy and budgetary consequences. More attention to courts'

Guatemalan Supreme Court has frequently overturned tax increases legislated in congress in accord with business interests (Sanchez 2009). Further research is needed to specify the sources of Guatemalan business power in this arena. Pro-business orientations are embedded in the constitution, reflecting strong business power at prior stages of policymaking in other arenas; Guatemala's 1985 constitution contains a prohibition on double-taxation that has been invoked to strike down new taxes (Sanchez 2009, IADB). However, business power in contemporary periods is probably relevant as well.<sup>8</sup> Business actors have ample financial resources with which to challenge laws they oppose in the courts. And ongoing relationship-based sources of instrumental power in the judicial arena could also be salient. Kapiszewski and Taylor (2008: 743) note "the potential role of courts as reluctant veto points activated by other political actors;" courts might also respond with enthusiasm to particular political actors. Examining the social and political origins of the judiciary in highly unequal (and/or ethnically divided) countries and the impact of justices' political identities and social backgrounds on their rulings could shed light on potential sources of business power in this arena. As Kapiszewski and Taylor (2008: 754) observe:

There has been little analysis (in English) of Latin American judicial elites. For the most part, we know little about the backgrounds, ideologies, or preferences of the region's judges and justices, and have barely begun to explore the politicization of the region's judiciaries or the implications of that dynamic for those who populate Latin American courts... justices' ideology, culture, and attitudes must exert some effect on their decision-making.

### ***Business Politics and the "Public Good"***

This research provides a different perspective on key aspects of business politics and the policy outcomes with which they are associated. Leading literature on business politics emphasizes the positive contributions that strong business associations and institutionalized government-business consultation can make to the "public good," particularly in the realm of macroeconomic policy and governance. In accord with literature on corporatism, Schneider (2004: 210) argues that "stronger associations in Mexico, Chile and Colombia made more visible and consistent contributions to economic governance and democratic governability than their institutionally weaker counterparts in Brazil and Argentina." Schneider discusses contributions in a number of areas, including control over inflation, trade negotiations and regional integration, and sectoral governance. In Chile, for example, Schneider describes the virtues of "coordinated policy reform," successful delegation of regulatory functions to business associations, and other positive outcomes associated with the existence of strong peak associations and government-business consultation. Schneider (2004: 57) does note several caveats; for example, he observes: "strong associations pose fundamental problems for democracy, especially to the extent that they overrepresent business and displace other groups," a problem also identified in earlier literature on corporatism. But overall, his assessment of strong business associations and government-business consultation is quite favorable.<sup>9</sup> Weyland (1996, 1997) follows in a similar vein, emphasizing the advantages for policymaking that arise from peak associations' ability to aggregate business interests, enforce bargains, and promote longer time horizons. Schneider (2003: 244) and Handley (2008: 247) also comment on the desirability of strong peak associations from a developmental perspective; for example, in Handley's words, they can provide the government with information about "what is really going on in the market." Various authors have also argued that where consultation with business is institutionalized, rent-seeking and corruption in business-government relations may be less pervasive (Arce 2005: 44, Schneider 2009,

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willingness and ability to engage in social policy-making and to the implications for governability and democratic stability is certainly warranted."

<sup>8</sup>Aside from the prohibition on double taxation (article 243), it is not clear that Guatemala's constitution differs much in its references to taxation from Chile's, where the court has not played an active role in declaring taxes to be unconstitutional. Each of these constitutions, for example, has prohibitions against confiscatory, disproportionate or otherwise unjust taxes that could in theory be invoked to overturn tax increases, so other factors are likely relevant in explaining the judicial role in Guatemala.

<sup>9</sup>Haggard, Maxfield and Schneider (1997: 51-52), Thorp and Durand (1997), and IADB (2006) also emphasize positive contributions.



Handley 2008). Finally, strong business associations may place salutary limits on the power of the state (Schneider 2003: 246-7, Moore 2004: 312).<sup>10</sup>

In contrast, while not denying these potential contributions to good macroeconomic outcomes and governance, I emphasize that strong business associations and institutionalized consultative arrangements in highly unequal societies may impede redistribution, which can make positive contributions to other aspects of the “public good:” social stability, development, and the quality of democracy.<sup>11</sup> In Chile, encompassing business associations and government-business concertation helped to keep revenue-raising, equity-enhancing tax reforms, as well as other redistributive policies, off of center-left governments’ agendas. Inadequate tax revenue limited governments’ ability to expand social spending. While Chile may be Latin America’s leader in poverty reduction, beneficiaries of anti-poverty programs remain in highly precarious economic situations. Silva (1998: 238) recognized the advantages concertation affords business, to the detriment of redistribution and prospects for social democracy, although he did not discuss the extent to which this and other sources of instrumental power restricted the government’s agenda. Similarly, business in Bolivia has used strong peak associations to fight redistributive policies. Beyond their successful resistance to elite-targeted taxes in 2004, business associations have played a leading role in the Santa Cruz-based “conservative autonomy movement,” which has sought to shield elites from the redistributive designs of the national government led by President Morales, particularly in the area of land reform (Eaton 2007, forthcoming). Among other concessions, the business-led movement has secured grandfathered exemptions for landowners from new limits on the admissible size of landholdings legislated by the national government (Eaton, forthcoming: 13). While Bolivia’s business associations may serve the beneficial role of checking the authority of a government prone to circumventing established political institutions, the concentration of land tenure in Bolivia has been a long-term problem that must be resolved for the sake of social peace and equitable development. Strong business peak associations in Guatemala have also helped to prevent much needed tax increases and redistributive reforms, stymieing realization of revenue and social spending targets specified in the Peace Accords (Dossal 1995, Fuentes and Cabrera 2006, IADB 2006, Sanchez 2009).

Of course, business may accept redistributive reforms in some cases, due to strategic considerations and/or long-term interests calculations, in which case strong business associations and government-business consultation may make more positive contributions to equitable development. More research on the conditions under which organized business in extremely unequal societies is likely to accept redistributive policies would be highly valuable.<sup>12</sup>

### *Insights into Tax Politics*

Finally, I offer several observations on the nature of tax politics that have not received sufficient attention in existing literature. First, different tax policy areas can give rise to different politics, and outcomes may accordingly vary across policy areas. The idea that different policies can give rise to different politics is well established in political science. Authors have recognized that taxation in general is characterized by the immediacy and certainty of the costs it imposes, which sets it apart from other policy areas like privatization, trade liberalization, or regulation (IADB 2006: 5-95). However, few studies have systematically compared politics and outcomes across distinct tax policy areas.<sup>13</sup> A number of authors have drawn distinctions between very broad categories of taxes. For example, Melo (2007) argues that governments in unstable environments increase “easy to collect” taxes rather than “hard to collect” taxes, Wibbels and Arce (2003) and other authors examine “taxes on capital” (corporate income

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<sup>10</sup>This point may be particularly relevant for Africa, where authoritarian rule remains prevalent.

<sup>11</sup>See for example Alesina and Rodrik 1994, Birdsall and Londoño 1997, Diamond 1999, López 2003, World Bank 2004, Karl 2005.

<sup>12</sup>Schneider and Soskice’s (2009) work on hierarchical capitalism and inequality provides insights as to why business in Latin America is unlikely to support redistributive policies; for example, most businesses have little need for skilled labor.

<sup>13</sup>Eaton (2002) disaggregates taxation, but his study primarily examines a single tax policy area: the VAT. Hart (2009) disaggregates tax revenue more extensively in his regression analyses; more research in this direction is needed. However, in-depth, comparative case analysis must supplement large-N analysis.

tax and employer social security contributions) as opposed to “taxes on labor” (consumption taxes, social security taxes and individual income tax) to assess globalization hypotheses, welfare state literature has noted the political pitfalls of increasing taxes that are highly visible as opposed to taxes that are hidden to the taxpayer, and Moore (1998) argues that reliance on “unearned” vs. “earned” revenue sources (eg, revenue that requires significant organizational effort and engagement with citizens) affects state responsiveness to citizens. Applying these broad categories has given rise to interesting hypotheses and findings. Yet all of these categories lump together taxes that may generate very different political dynamics. For example, the administrative difficulty of collecting taxes need not correlate with political difficulty of legislating taxes. Taxes that are administratively easy to collect can be politically difficult to legislate, as evidenced by the copper royalty in Chile, or they may be politically easy to legislate, as with export taxes in Argentina from 2002 until 2008. Turning to “taxes on labor,” the politics of individual income taxation will vary depending on whether reforms target upper-income groups or affect wage labor more broadly; likewise, the politics of taxing consumption will be very different from the politics of taxing income due to the very different incidence of these taxes. Similar comments apply to “earned” versus “unearned” tax categories. Authors have scored both property taxes and head taxes as “highly earned” (Toye and Moore 1997), despite the fact that the former are generally highly progressive and the latter highly regressive and as such will generate very different politics involving different actors and even different levels of government. Research on building tax capacity and research on political or regime characteristics of different kinds of tax states would therefore benefit from disaggregating taxation to a much more significant extent.

The business power and reform strategies framework employed here is well-suited for both identifying and explaining variation in tax politics across tax policy areas. Instrumental power may vary across sectors, creating different political constraints on tax policies with sectorally-differentiated impact. Structural power inherently varies across policy areas, since different policies will affect and send different signals to different economic actors. And tax-side reform strategies available to governments vary across tax policy areas as well. Tax tools can occasionally be devised to obfuscate incidence and therefore reduce business opposition and/or concerns over structural power. Targeted, progressive tax increases allow vertical equity appeals, while broad-based tax increases do not. And taxing extractive sectors allows the possibility of appeals to nationalism.

A second observation emerging from this study is that tax reform involves political dynamics at the national level. A large body of research has examined the role of international factors in tax reform in Latin America and beyond, including epistemic communities, international tax competition, regional integration and pressure from financial institutions and foreign nations. These international factors can certainly be important. However, greater attention to domestic politics in general, and business’s instrumental power in particular, is merited, particularly in the case of second-generation tax reforms. International pressures were all but absent for many of the reforms examined in this study. And in cases where international pressures did exist, their influence was strongly mediated by domestic variables, as with tax agency access to bank information. Both Chile and Argentina experienced pressure from the US and the OECD to loosen banking secrecy rules; Chile’s lack of progress in this area as compared to Argentina can only be understood by examining the domestic-level determinants of business power. And while the need to attract mobile international capital may place an upper bound on the degree to which business profits can be taxed, significant cross-national variation in corporate taxation exists and may arise largely from variation in the domestic business sector’s instrumental power.

Third, building tax capacity in highly unequal societies tends to raise issues of redistribution that may instigate major political battles with economic elites. As was discussed at length in Chapter 1, because taxable resources are so concentrated in Latin America, and because the majority of the population is so poor, all taxes to a significant extent extract resources predominantly from elites. In countries that implemented first-generation reforms bolstering consumption taxes, raising revenue is even more clearly a problem of tapping elite resources. In Chile, Argentina, and Bolivia, as with most countries in Latin America, income and profits constitute a major, under-tapped revenue base that has begun to attract governments’ attention as they struggle to satisfy their fiscal needs and/or expand their

range of policy tools for reducing inequality.<sup>14</sup> As indicated by cutting edge research in economics and recognized by many Latin American tax experts, progressive taxation can make a non-trivial contribution to redistribution, contrary to the predominant view in policy circles and among political scientists that treats targeted social spending as the only relevant tool for redistribution.

Economic elites themselves recognize taxation as a redistributive tool. Unless the state is so captured that tax revenue is used largely for the benefit of the elites from whom it is extracted, elites can expect that higher taxation will lead to net redistribution from their own pocketbooks to other sectors of society. And in some cases, elite resistance to redistribution takes place primarily on the tax side of the fiscal equation, rather than the spending side. In Chile, for example, most political actors agreed on a model of targeted social spending to alleviate poverty, but business and their political allies contained the redistributive potential of those programs by limiting the tax revenue available to fund them. The Republican Party in the United States pursued a similar strategy. Business in Guatemala has also hindered redistributive state spending by consistently opposing tax increases. The problem of taxation, inequality, and redistribution is likely to persist in Latin America and merits further attention from political science.

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<sup>14</sup>These points are made for example in the “Social Agenda for Democracy in Latin America,” spearheaded by former Peruvian president Alejandro Toledo with participation from 20 former Latin American presidents (GCDD 2009: 23, 24).

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