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Taxation, Inequality and Fiscal Contracting in the Americas

Richard M. Bird and Eric M. Zolt*
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Abstract

Since 2000, Latin America has become less unequal, with lower levels of poverty, and likely greater economic mobility. Over a longer time period, the story in the United States is much different. The United States has become more unequal, with relatively high poverty levels, and likely less economic mobility. While these changes largely result from broader economic and political factors, government fiscal policies play some role in changing market outcomes. This Article examines how changes in levels of inequality may influence taxing and spending policies.

It suggests that in both parts of the Americas changing economic and political realities may contribute to a changing 'fiscal contract.' One contributing factor is the economic circumstances of the middle class. In Latin America, improvements in the economic status of the middle class may call for different tax and spending policies. In the United States, the increased economic vulnerability of the middle class and the perceived decline in economic mobility may drive change. In both regions, the extent and nature of change may depend largely on the extent to which the middle class come to think that they may be better served with higher (or lower) taxes (on them, and on the wealthy) and more (or less) robust social spending programs.

Keywords: Fiscal redistribution, taxation, inequality, fiscal contract, Latin America, United States

JEL Classification: D31, H11, H23, O54, P52

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Taxation, Inequality and Fiscal Contracting in the Americas

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What a difference a decade makes. Since 2000, Latin America has become less unequal, with lower levels of poverty and likely greater economic mobility (Lustig, Lopez-Calvo and Ortiz-Juarez 2012), assisted in part by more progressive fiscal policy (Mahon 2012). In contrast, over a longer time frame, the United States has become more unequal (Piketty and Saez 2003, 2013), while poverty has remained relatively constant (U.S. Census Bureau 2012), economic mobility has likely declined (Hungerford 2008), and tax and spending policies have become less effective in reducing inequality (Harris and Sammartino 2011).

Tax and spending policies are notoriously sticky. Fiscal patterns reflect a basic equilibrium of political interests that strongly influence the makeup of tax and spending policies. Many factors contribute to the combination of policies that constitute the "fiscal contract" in a country, but once a country adopts a particular fiscal pattern, although many economic and political changes may occur, major changes are challenging.[1] Modern democratic societies tend to gravitate towards two distinct fiscal equilibria: big government, with redistributive expenditures but less progressive taxes—like Sweden—and small government, with more progressive taxes but less redistribution—like the United States (Alesina and Angeletos 2005). Although it is difficult to predict when and how a country's fiscal contracts may change, one major factor is arguably the changing economic circumstances of the middle class. In Latin America, improvements in the economic status of the middle class appear to be an important reason for recent changes. In the United States, the increased economic vulnerability of the middle class and the perceived decline in economic mobility may drive change. In both regions, the extent and nature of change may depend largely on the extent to which the middle class come to think that they may be better served with higher (or lower) taxes (on them, and on the wealthy) and more (or less) robust social spending programs.

As a region, Latin America has long led the world in terms of income inequality (Blofield 2011). Latin American fiscal policy, especially tax policy, did little to remedy this state of affairs Mahon 2011). In contrast, over most of the 20th century income increased in the United States for all and income inequality declined. The United States has long been seen as a land of opportunity, where hard work, thrift and personal responsibility lead to economic reward.

[1] We use the term fiscal contract to refer to the combination of tax and spending policies in a particular country. On the tax side, this includes choices as to the level of taxes, the relative use of different types of taxes to fund government operations, and the distribution of tax burdens among income groups. On the expenditure side, this includes choices as to the level of public social spending, the relative allocation of funds among different types of social programs, and the distribution of the benefits of social spending among different income groups. We broadly adopt the 'fiscal contract' view of the state set out by North and Weingast (1989) and developed further by Timmons (2005).

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Although this is not always recognized, it has also been a country with more progressive income taxes than most other countries. The story of development in the Americas over the last century is broadly that regions with high inequality in the south adopted fiscal policies resulting in lower tax revenues and lower social spending levels than those in the north with lower levels of inequality (Sokoloff and Zolt 2006). Recently, however, divergences from these broad trends have occurred.

Although experiences in Latin America are as varied as the countries of the region, Lopez-Calva and Lustig (2010) show that the story of recent developments is both economic and political. Economic growth has produced more and better jobs and hence a less unequal pre-tax (market-generated) distribution of income, with an expanding middle class and an increasing income tax base.[2] While tax burdens (tax-to-GDP ratios) in most Latin American countries (other than Argentina and, especially, Brazil) remain relatively low for the level of economic development, over the last 20 years tax burdens have been increasing faster in Latin America than in any other region in the world (Ter-Minassian 2012). Although taxes have generally not become much more progressive in many countries transfers have, with the result that poverty was reduced in both relative and absolute terms.[3] While no Latin American country has yet managed to tax the rich very effectively and the long-term sustainability of recent trends is far from certain, these trends are very different than those widely predicted a few years ago.

The story in the United States over the same time period is very different. The pre-tax distribution of income changed dramatically over the last 30 years as incomes of the top quintile (particularly the top 1 percent) have increased substantially while income growth for most of the rest of the population has remained relatively flat. The result has been increased inequality, no reduction in poverty levels, and increased middle-class vulnerability.

The United States has a long tradition of small government and self-reliance with relatively low levels of taxes and social spending. Its taxes are still relatively low but the level of public spending has expanded substantially, primarily because of the rapid growth in social spending (including tax subsidies for health, education, housing, and retirement savings). This increase has been financed partially by increased taxes from the rapidly growing income of the wealthy but mainly by increased debt.

The dramatic increase in top incomes has allowed the share of tax revenues from personal income taxes to remain high (OECD 2012). While the relative amount of the total income tax burden has remained relatively constant, the allocation of the tax burden among different income classes has not (Stark and Zolt 2013). Over 90 percent of the total personal income tax is now

[2] Azevedo et al. (2013) show that the regional decrease in inequality has been driven largely by changes in labor income reflecting both improved levels of education and demographic factors although they caution that more investment in the right kind of education and training is needed to sustain recent trends.

[3] As Lustig and Higgins (2012) show with respect to Brazil, however, even when taxes and transfers have significant effects on poverty and inequality, different 'poor' and 'non-poor' groups may be affected differently.

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paid by the top quintile while the middle quintile's share declined over the last 20 years to less than 3 percent in 2009 (CBO 2012).

On the other side of the budget, public social spending has increased but more goes to the elderly (without regard to need) than to the poor (Harris and Sammartino 2011), and an increasing amount of indirect social spending (through tax subsidies) also goes to the upper-middle class and the wealthy. The middle class is being squeezed: over the last decade "the middle class has shrunk in size, fallen backward in income and wealth, and shed some—but by no means all—of its characteristic faith in the future" (Pew Research Center 2012).[4]

Is the United States becoming more like Latin America? The increasing concentration of income at the top, persistent levels of poverty, declining economic mobility, and declining public services suggest that the answer is "yes." Inequality has reached levels not seen since the 1920s, and the gap between the haves and the have-nots with respect to equality of opportunities for quality education and academic achievement continues to grow (Reardon 2011). Fiscal challenges and tax competition may, in the end, break the United States' heavy dependence on the federal personal income tax and result in the introduction of a VAT or some other type of broad-based consumption tax. However, whatever happens in the next decade or so, the United States will not morph into Sweden.

Is Latin America likely to follow the (former) U.S. small government model with relatively low levels of public social spending? Or will different countries in the region go different ways, with some continuing to be relatively small welfare states (such as Mexico) and others moving over time to a more European approach with relatively larger welfare states (such as Brazil)? Even countries that follow the first approach may continue to expand their social spending, in part for political stability reasons. However, any such expansion of the public sector will likely be financed mainly by increased revenues from the VAT with countries following the European model increasingly supporting it by revenues from a more robust income tax system.[5] In either case, any new tax revenue will have to come from not only the wealthy but also the increasingly important middle class. In order to implement and sustain such tax changes, countries may have to strengthen the 'Wicksellian connection' between taxes and spending (Breton 1996), for instance by matching tax increases with social programs applying to a larger population in contrast(or addition) to the more targeted (poverty-oriented) conditional cash programs adopted in Brazil and Mexico.

[4]Almost every study, survey and commentator seems to have a different definition of the 'middle class': see .e.g. Banerjee and Duflo (2008), Lora and Fajardo (2011), and Atkinson and Brandolini (2011).

[5] In an analysis of fiscal redistribution in Latin America, Barreix, Roca and Villela (2007) emphasize the need to strengthen (and make more progressive) both these pillars of the tax system. However, on the spending side, they urge still more targeting of expenditures on distributive grounds rather than the 'universalist' expansion to include significant benefits to the middle class we suggest may be required.

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Inequality, Poverty, and Economic Mobility

There have been substantial changes in inequality, poverty, and economic mobility in the Americas over the last 40 years. While these changes largely result from broader economic and political factors, tax and spending policies play a role in changing market outcomes.

Inequality and Poverty

The most common summary measure of income inequality is the Gini coefficient, with a higher number representing greater inequality. Table 1 shows Gini coefficients for income inequality for the last 40 years for five major countries in Latin America and for the United States and Canada.[6] Income distribution clearly remains far more unequal south of the border. Over the last 40 years, however, while the average Gini coefficient rose by only about 4 percent in the five Latin American countries compared, it increased by 12 percent in North America. The decline in Gini coefficients in Latin America from an average of .56 in 2000 to .52 in 2010 is striking compared to the continued rise in the Gini coefficient for the United States over the same period. For Latin America as a whole, the unweighted regional Gini coefficient (for household per capita income) declined from .53 in the late 1990s to .50 in 2010, with 12 of the 17 countries for which reasonably comparable data are available showing a statistically significant decline (Lustig, Lopez-Calvo and Ortiz-Juarez 2012).

Table 1. The Distribution of Income: Gini Coefficients

Country	1970	1980	1990	2000	2010
Argentina	.36	.41	.50	.54	.51
Brazil	.58	.60	.63	.64	.56
Colombia	.43	.53	.53	.57	.56
Mexico	.54	.50	.54	.54	.49
Peru	.56	.57	.51	.53	.46
United States	.32	.34	.35	.36	.38
Canada	.30	.30	.29	.32	.32

***Sources*:** For Latin America: Gini coefficients for earlier years from WIDER http://www.wider.unu.edu/research/Database/en_GB/wiid/ and since 1990 from CEPAL http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp ; coefficient shown is for year nearest date indicated and coverage varies from country to country (e.g. only urban sector for Argentina). For North America: Gini coefficients from stats.oecd.org (for mid-decade in 1970s and 1980s and for late 2000s for last column). Although every effort has been made to make the data as comparable in coverage, concept and year as possible, there are wide variations from country to country and, over time, even within particular countries. Details of data concepts and sources may be found in the sources indicated.

[6] Although the measures shown in Table 1 do not all refer to exactly the same concepts in all countries at all periods, they are largely based on household estimates (in per capita terms) of disposable income: that is, gross money income less direct taxes plus direct transfers (Goni, Lopez and Serven 2008). These coefficients provide about as good a set of numbers as exist to make broad comparisons between countries over this time period. (For other ways to measure Gini coefficients, see http://website1.wider.unu.edu/wiid/WIID2c.pdf.)

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There are many different ways to measure income inequality. Table 2 sets out several different measures of changes in Latin American income distribution over the last two decades.[7] Over this period, the share of income going to the top 10 percent of the population declined sharply in Brazil, Mexico and Peru, remained almost unchanged in Argentina, and increased in Colombia. While the ratio of per capita income in the top decile to that in the bottom four deciles rose slightly in Argentina and Colombia, it declined significantly in the other three countries. Finally, in all five countries the share of the population living below the poverty line declined sharply. In summary, it seems clear that on the whole, income inequality and especially poverty decreased sharply in recent years, particularly in Brazil, Mexico and Peru.

Table 2. Income Inequality and Poverty in Latin America, 1990-2010

Country and Year		Share of personal income going to top decile	Ratio of per capita income in top decile to that in bottom 40 percent	Share of population living below poverty line
Argentina	1990	39.4	13.5	16.1
	2000	42.8	16.6	23.7
	2010	39.8	15.1	8.6
Brazil	1990	50.6	31.2	48.0
	2000	53.0	31.9	37.5
	2010	45.0	21.1	24.9
Colombia	1990	42.6	16.7	56.1
	2000	46.4	22.3	54.9
	2010	44.0	20.1	37.3
Mexico	1990	43.8	17.2	47.7
	2000	43.2	17.9	41.1
	2010	37.4	12.8	36.3
Peru	1990	n.a	n.a.	n.a.
	2000	43.6	19.5	48.6
	2010	34.6	11.4	31.3
Average Change 2010/1990		-8.8%	+2.4%	-33.7%

***Source*:** CEPAL http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp; Argentina for urban only; for years closest to those indicated. As indicated for Table 1, although we have tried to be as comparable as possible over both countries and time, this table should be considered only an approximation, and other numbers may be found in other sources for what seems to be the same concept: for more detailed information on the data, see the source cited.

In the United States, between 1979 and 2007, households at the top of the income distribution experienced by far the largest gains in both relative and absolute income, with the pre-tax income of the top 1 percent almost tripling in this period (Harris and Sammartino 2011). Over the last three decades, the income of households in the top quintile (not including the top 1 percent)

[7] How much inequality has changed depends on not only what is measured but for whom it is measured. The data in Table 1 (and Table 2) are at the household level (in per capita terms). Data on individuals emphasize changes in labor income and wage differentials, but data on households better measure the economic well-being of individuals living together.

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increased by 65 percent; income growth was 40 percent for the middle three quintiles and only 18 percent for the lowest quintile. The rich got richer, and the middle class and the poor, while better off in absolute terms, became relatively worse off. The share of income for the top decile in the United States increased from about 40 percent in 1990 to slightly less than 50 percent by 2008 (Piketty and Saez 2013).[8] In contrast, in the five Latin American countries over the last two decades, the share of income for the top decile decreased by 9 percent, the share of the second and third quintiles increased by 6 percent, and the share of the bottom 40 percent (the poor) increased by 9 percent.[9]

Poverty rates in the United States remain substantially higher than in most high-income countries, with over 46 million people living in poverty (slightly less than 16 percent of the population) and with much higher poverty rates for children under 18 (21.4 percent), and especially for children under age 6 from female-headed households (57.2 percent) (U.S. Census Bureau 2012).

Intra-generational and inter-generational economic mobility

Income equality appears to be linked to social mobility largely through its effects on the extent to which people have equal access to opportunities for improvement, rather than on its direct effects on individual effort (Brunori, Ferreira, and Pangini 2013). There are two major approaches to examining economic mobility. Intra-generational mobility focuses on the individual to determine how much his or her absolute or relative position has improved over time compared with the general population. Inter-generational mobility measures seek to estimate how much of a child's income is attributable to parental income.

Ferreira et al. (2013) find that the impressive change in income distribution in Latin America over the last decade or so has resulted in a substantial expansion of the middle class (which they define as those with income, at purchasing power parity exchange rates, of between USD 10 and USD 50 per person per day) from 20 to 30 percent of the population. Although an annual per capita income of $3650 may not sound like much to North Americans, Ferreira et al. (2013) suggest that it is sufficient to provide both a basic middle class standard of living and some resilience to economic shocks. That the group reaching this level increased by 50 percent in so little time is a remarkable achievement but there remain many poor people in Latin America: 68 percent of the regional population lived below the middle class level (as defined above) in 2009 compared to about 78 percent in 1995. And 30 percent were still classified as poor (with incomes

[8] In all countries, wealth is more concentrated than income (Wolff 1996). Over the last 50 years, the Gini coefficient for wealth distribution in the United States has increased from .80 in 1962 to .87 in 2010 (Wolff 2012). While wealth distribution data are even harder to assemble and compare than income distribution data, the Gini coefficient for wealth distribution in 2000 was even higher in the United States than in the three Latin American countries for which data were available, and markedly higher than that in Canada (Davies et al 2008). As with income there are different ways of measuring wealth distribution, which may often yield different results. For a comprehensive discussion, see Davies (2008).

[9] Calculated from data in http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp.

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of less than USD 4 per day) in 2009 compared to 44 percent in 1995. Few people move from poverty to middle class within a few years. Most who exited the 'poor' category instead moved into what Ferreira et al (2013) call the 'vulnerable' class, with an income between $4 and $10 a day, an amount that is decidedly better than poverty but not enough for comfort. This vulnerable group (which grew from 34 percent in 1995 to 38 percent in 2009) is now the largest group in Latin America. Although the absolute size of the vulnerable group has remained relatively constant, its composition changed substantially over this period, as many who were vulnerable 15 years ago moved to the middle class and were replaced by others who were formerly poor.

Ferreira et al. (2013) document a surprising degree of intra-generational income mobility in Latin America in recent years. However, Table 3 suggests that inter-generational income mobility, as defined by the incomes of children compared to those of their parents, has not experienced the same change: inter-generational mobility remains considerably less in Peru and Brazil than in the United States, although the gap between Argentina and the United States is smaller. [10] While a few European countries, such as the United Kingdom and Italy, have economic mobility levels comparable to that of the United States, most European countries have inter-generational income mobility levels much closer to Canada than to either the United States or Latin America (Corak 2012). The higher the inter-generational income elasticity, the more likely it is that the children of high-income parents will also have higher incomes. For example, in Peru, if one father makes 100 percent more than another, then the son of the first is likely to earn about 70 percent more than the son of the second. In the US (and Argentina), the son of the richer parent is likely to earn about 50 percent more, and in Canada (and northern Europe), the son of the richer parent will earn only 20 percent more. The degree of economic mobility in Latin America and the United States, when measured in these terms, appears to be substantially less than mobility in either Canada or most of Europe.

Table 3. Economic Mobility across Generations

Argentina	.49
Brazil	.58
Chile	.52
Peru	.67
United States	.47
Canada	.19

[10] As with income inequality, there are many ways to measure income mobility and different measures may give very different results. Measuring income persistence across a single generation may not be the best measure of inter-generational income mobility (Jantti et al. 2006). The measures reported in Table 3, however, are the only ones available for many Latin American countries; moreover, other studies which employ different measures show comparable results when comparing the United States to European countries (Jantti et al. 2006). On the other hand, Clark (2013), using a quite different, surname-based approach, estimates both that social mobility levels in the United States are no lower than in other countries and that they have not declined in recent years. And in a recent study, Krebs, Krishna and Maloney (2013) find that most estimates of income mobility in Mexico are subject to measurement error or transitory income shocks and likely provide little evidence of economically significant effects.

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Source and Notes: The number reported is the 'inter-generational elasticity of earnings' as measured by the percentage difference in the share of the child's earning associated with the percentage difference in the parent's earnings from Corak (2012)

Access to quality education is a major factor explaining differences in economic mobility across generations and among countries. The United States was a world leader in providing first common school and later high school and university education (Goldin and Katz 2008), while Latin American countries did much less to support public education (Engerman and Sokoloff 2001). In recent years, however, the academic achievement gap between rich and poor groups has widened substantially in the United States (Reardon 2011). In contrast, some Latin American countries, although still notably unequal in terms of access to quality education, have made substantial progress in improving the educational attainment of previously disadvantaged groups (OECD 2012c), as well as in improving the quality of education by international standards.[11] Despite substantial progress in increasing the number of children in school, most Latin American countries face substantial challenges in increasing instructor quality and improving the learning environment for poor children (Levy and Schady 2013). In both regions better pre-school programs targeted at disadvantaged children would be helpful in narrowing the educational achievement gap between the rich and the poor. Still, unless reversed, current trends in education may reduce economic mobility in the U.S. and increase it in Latin America.

Changing Fiscal Policy

Although income in Latin America remains highly unequally distributed, there has been considerable improvement in a remarkably short time. Although two-thirds of this improvement, and three-quarters of the rise of the middle class (as defined in Ferreira et al. 2013), is attributable to the rise in average incomes with economic growth rather than to the decline of income inequality, explicit redistributive policies, especially the expansion of targeted social spending, were important in several Latin American countries.

Countries differ in the priorities attached to the related but distinct objectives of reducing inequality, reducing poverty, and increasing economic mobility. Moreover, such priorities may change over time. We focus largely on the extent and ways in which fiscal policy affects redistribution between three groups: the 'rich' (the top end of the income distribution, defined variously depending on the data), the 'poor' (the bottom 40 percent or so) and the huge and varied group in between these extremes called, for want of a better word, the middle.[12]

[11] On the latter point, see the analysis of PISA data in Ferreira et al. (2013), as well as http://en.wikipedia.org/wiki/Programme_for_International_Student_Assessment#2000.E2.80.932006.

[12] Many discussions of fiscal contracting focus on the rich and the poor (e.g. Ardanaz and Scartascini 2011) or ignore the critical link between the two sides of the budget (e.g. Hart 2010). In contrast, our focus here is specifically on critical changes in the middle class and the possible implications of these changes for both sides of the budget.

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Social spending

Table 4 highlights the recent substantial increase in public social spending in Latin America.[13] Much of the increase is attributable to increases in social security spending (most notably in Colombia and Mexico). Surprisingly, despite the better educational outcomes mentioned earlier, the share of social spending going to education actually declined in many Latin American countries. Although increased public expenditure on education may not only increase economic growth but significantly reduce income inequality (Canavire-Bacarreza, Martinez-Vazquez and Vulovic 2012), the decline in public educational spending may not have had a particularly adverse effect on inequality because such spending often primarily benefits higher income groups due to the combination of free (or low cost) tertiary education with the much higher percentage of privately educated higher-income children qualifying for university education.

Table 4. Social Spending in Latin America, Selected Years, 1990-2008 (as percent GDP)

Country	1990	2008	Percentage Increase Over Period	Education As Percent Social Spending 2008	Social Security As Percent Social Spending 2008
Argentina	18.6	24.0	29	24.9	46.1
Brazil	17.6	24.8	41	21.9	51.6
Colombia	6.4	12.6	97	22.3	55.8
Mexico	5.5	10.0	82	35.6	26.4
Peru	4.0	8.7	118	32.1	35.1

***Source and Notes**:* Data from http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp. Central government only for Colombia and Peru. Figures for Mexico are probably underestimated owing to difficulty in estimating some subnational expenditures. Social spending includes public sector expenditure on education, health and nutrition, social security, employment, social welfare, housing, and water and sewerage.

On the whole, social spending appears to have contributed to reducing income inequality in Latin America. In Brazil and Mexico, for example, cash transfer policies accounted for about 20 percent of the decline in inequality (Ferreira et al. 2013), while in Colombia an educational voucher scheme allowing poorer students to attend better schools appears to have had significant effects in improving educational outcomes (Angrist et al. 2002). Other studies in Colombia and Chile demonstrate the possible gains from such innovations and reinforce the notion that one important way forward for Latin America may lie in increasing the inclusivity of such key public institutions as schools (Ferreira et al. 2013).

An important outcome of extending and improving such critical public services may be to encourage the expanding middle class to buy into the expansion of the state sector rather than

[13] A similar rising trend is shown for social spending per capita, especially in Argentina, in Afonso et al. (2012) who use essentially the same data set as Table 5.

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following the well-established path of the wealthy and opting out. One factor explaining Latin America's historical inequality has been persistent inequity in access to education combined with poorly designed public social insurance transfers (de Ferranti 2004). Better educational opportunities for the children of the emerging middle class were a main driver in building local and state capacity in North America in the 19th and the first half of the 20th century (Sokoloff and Zolt 2006). Especially in regions with greater equality, local governments were successful in expanding their fiscal base to provide more and better local goods and services. In Latin America, however, the wealthy have long avoided public health and education services in favor of costlier, higher quality private services. The 'exit' of much of the politically articulate population from public services means that their 'voice' has not been heard with respect to the need for improving public services (Hirschman 1970). However, with greater prosperity, more democracy, and increased decentralization, it may now be both possible and desirable to establish stronger links between what people are willing to pay for and what they receive from the public sector.

Most Latin American countries supply important services at two or three levels: private and public for education and private, social security (for salaried workers, financed through wage taxes), and public (for everyone else, financed through general tax revenue) for health, with public provision at the lower end of the quality spectrum in both types of services. Some countries in Latin America, such as Argentina, Brazil and Chile, introduced traditional compulsory social insurance schemes financed by payroll taxes even before World War II, like the United States. Others, including Colombia, Mexico, and Peru, followed in the 1950s, with Central American countries following suit in the 1960s and 1970s (Mesa-Lago 2008).[14] The coverage and benefits of these schemes varies from country to country, but in all cases the social insurance system is financed through payroll taxes. On average, the level of these payroll tax rates in 2011 was over 20 percent, compared to 17.35 percent in the United States, although with wide variation from country to country, ranging from 10.6 percent in Mexico to 45.148 percent in Colombia. Social security taxes are applied only in the formal sector of the economy. Similarly, the benefits from social programs financed by these taxes (which include both pensions and health services) may generally be claimed only by those who are or have been employed in the formal sector and have therefore contributed to funding the programs, although there is often no tight connection between taxes paid and benefits received (Social Security Administration 2012).

The social insurance systems in most Latin American countries are often characterized as deeply flawed, given their limited coverage of only the formal sector, the marked evasion even within that sector, and the fact that transfers are regressive in that they do not go to the poor. Indeed, a careful study of social transfers in eight Latin American countries (including the five on which we focus here) concluded that the existing social system is in general both "grossly inefficient

[14] For an interesting discussion of the relationship between tax policy, growth and inequality in Central America from a somewhat different perspective than that taken here, see Schneider (2012).

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and regressive" (Lindert, Skoufias and Shapiro 2006, 4), with the partial exception of the conditional cash transfer systems introduced recently in a few countries. Goni, Lopez and Serven (2008) estimate that about 70 percent of direct transfers go to the two top income quintiles in Latin America, compared to only about 40 percent in Europe, although taking in-kind transfers into account redressed the balance to a considerable extent .

In recent years, the United States has also seen major changes to its public social spending policies. The United States, although still a relatively small taxer, has nonetheless become a medium-sized welfare state. Indeed, the size of its welfare state is similar to that in many western European countries if allowances are made for U.S. tax subsidies for health, education, housing, and retirement savings (Zolt 2013) and income and consumption taxes imposed on transfer recipients in Western European countries (Fishback 2010). There have also been changes in spending patterns. The share of (politically popular) federal transfers going to the elderly rose over the last 30 years, from 62 percent in 1979 to 68 percent in 2007 (Harris and Sammartino 2011). One result is that the effectiveness of fiscal policies in reducing inequality has declined because transfers to the elderly are not conditioned on income. For example, in 1979, households in the bottom quintile received over 54 percent of transfer payments, but by 2007 their share had declined to 35 percent (Harris and Sammartino 2011).

Redistributive government spending can take the form not only of direct subsidies but also 'tax expenditures,' which tend to be distributed even less equitably. In the United States, for example, the top two quintiles receive about two-thirds of the benefits from tax expenditures for health care expenses and over 90 percent of the benefits from expenditures for retirement saving and home ownership incentives, although middle income groups also receive some benefits from these subsidies (Toder, Harris, and Lim 2009).

Taxation

Table 5 summarizes some key quantitative facts about taxation in the larger Latin American countries as well as the United States and Canada. In most Latin American countries, both tax ratios and the share of taxes coming from income taxation grew significantly over the last decade, in contrast to the decline in both ratios in North America. On the other hand, as the last column in Table 5 shows, a major difference is the dominant role of the personal income tax in the North and the dominant role of the corporate income tax in the South.

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Table 5. Trends in Taxation, 1990-2010

	Tax Ratio (%GDP)				***Of which Income Tax***				
Country	**1990**	**2000**	**2010**	**Change 2010/1990 (%)**	**1990**	**2000**	**2010**	**Change 2010/1990 (%)**	**Ratio of CIT to PIT (c.2007)**
Argentina	16.1	21.5	33.5	108	3.7	18.5	16.2	338	2.3
Brazil	28.2	30.1	32.4	15	18.1	19.3	21.2	17	2.0
Colombia	9.0	14.0	17.3	92	29.9	29.3	27.9	-7	n.a.
México	15.8	16.9	18.8	19	27.1	27.3	27.8	2	1.1
Peru	11.8	13.9	17.4	47	5.7	19.8	37.6	460	4.2
Unweighted Average	16.2	19.3	23.9	48	16.9	22.8	26.1	54	2.4
United States	27.4	29.5	24.8	-10	46.8	50.5	43.6	-7	0.3
Canada	41.9	35.6	31.0	-26	48.6	50.1	46.8	-4	0.3

Sources and Notes: Tax ratios from OECD (2012, 2012a); excludes local government for Argentina (provincial government included) and for Peru (except for 2010), and does not include fees levied on hydrocarbon production as taxes. "Income tax" includes all taxes classified as such in GFS (personal, corporate, withholding). Ratio of corporate to personal income taxes for Latin America from Cornia, Gomez-Sabaini and Martorano (2012); for North America, calculated from data in OECD (2012).

The key structural features of the tax system did not change significantly in Latin America, although corporate and personal income tax rates fell over this period in most countries while VAT rates rose slightly (Lora 2012). Not only have income tax rates declined, but the scope of the system has been altered considerably: it has changed from one which, on average, imposed tax liability at a taxable income level of about 60 percent of per capita GDP in the mid-1980s to one that started at 2.3 times per capita GDP a decade later. At the same time, the average level at which the top bracket takes effect has declined sharply from 121 times per capita GDP to only 21 times GDP**.** With considerable differences from country to country, personal income taxes have become much flatter, with top rates declining to levels comparable to the lower corporate rates**.** Nonetheless, the share of both income and total taxes collected from the rich (the upper quintile) also grew over this period, reflecting the continuing inequality of pre-tax incomes in Latin America and the increasing inequality in the United States and, to a lesser extent, in Canada.

As Mahon (2012, 1) notes, the available evidence supports the conclusion that "most Latin American fiscal systems have become somewhat more redistributive since 2000." Although most tax reforms in the region have shifted tax structures away from reliance on income taxes and towards consumption taxes, some countries (such as Peru) have sharply increased their reliance

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on income tax. All countries in the region have increased their tax-to-GDP ratios, in contrast to decreases north of the border.[15] Before 1970, most Latin American tax systems collected relatively little tax revenue, and did so in an inefficient and regressive way. Over the next few decades, while income tax rates were cut (in most countries without any offsetting base expansion) the role of the VAT was greatly expanded, with the important effect of strengthening tax administration. This reform greatly increased the capacity of the state. However, the main responsibility for redistribution remained on the expenditure side, and increases in social spending towards the end of the century (Table 4) resulted in spending becoming more redistributive in some countries (Barrientos 2011).

Mahon (2012) reports the results of 15 recent studies of fiscal redistribution in the five Latin American countries examined here. Table 6 illustrates several important points. First, first-order measures of the distributive effect of the fiscal system are small when measured in terms of changes in the Gini coefficient (which is more sensitive to changes in the middle of the income distribution than at the extremes). Second, such measures also often vary substantially from one year to another (or even for the same year, in the case of Colombia), in part because they are derived from a variety of different studies, often using differing incidence assumptions, particularly with respect to the incidence of the corporate income tax. Third, social spending programs are generally more effective than taxes in achieving redistribution. Fourth, in three countries total fiscal distribution increased over this short period, while in Colombia and Peru it appears to have decreased slightly. Finally, although there are exceptions, consumption taxes generally appear to be either slightly regressive or neutral, while income taxes are generally progressive.[16]

[15] The sharp drop in Canada's tax ratio from its 1990 all-time high reflects the strong fiscal retrenchment required during the 1990s to reduce the high budget deficit and the more restrained spending of subsequent years. For a more detailed comparison of recent trends in Canada and the U.S., see Bird and Zolt (2013).

[16] This conclusion is even more tenuous than the others because in addition to the general problems of different sources, methods, incidence assumptions, and time periods, the scope of the 'consumption' and 'income' taxes being compared varies across countries and years.

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Table 6. Recent Studies of Fiscal Redistribution in Latin America

Country	Year	RS Index Spending	RS Index Taxation	Combined RS Index	RS Index Consumption Taxes	RS Index Income Taxes
Argentina	2001	.00	+.01	+.01	.00	+.01
	2004		-.009	-.01		
	2006	+.091	+.019	+.11		
Brazil	1998	+.03	.00	+.03	.00	.00
	2003	+.015	-.005	+.01	-.018	+.013
	2006	+.07	+.014	+.08		
Colombia	2003	+.050	.000	+.05	-.004	+.008
	2003	.00	.00	.00	-.01	+.01
	2004	+.006	-.001	+.005		
Mexico	2000	+.01	+.01	+.02	.00	+.01
	2004	+.018	.000	+.02		
	2006	+.037	+.003	+.04		
Peru	2000	+.035	-.008	+.03	-.012	+.0013
	2002	.00	-.01	-.01	-.02	+.01
	2004	+.005	.000	+.005		

Source: Mahon (2012). The RS (Reynolds-Smolensky) index is the difference between the Gini coefficients pre- and post-spending or taxation as the case may be. By convention, a positive value indicates a progressive effect (that is, Gini declines) and a negative value a regressive effect.

Despite the increase in the importance of income taxes in most major Latin American countries in recent years, there likely has not been a significant change in the redistributive effect of the tax system. One reason is that relatively little income tax revenue in Latin America comes from personal income taxes, the only important progressive element of the tax system. The incidence of the corporate income tax, much more important in most Latin American countries, may fall in open economies in part on low-income workers and consumers rather than high-income profit recipients (Harberger 2006). On the other hand, market fragmentation and government regulations may mean that a considerable share of corporate profits arises from economic rents which, if not collected in taxes, will accrue to (presumably wealthy) corporate owners (Shah and Whalley 1991). Although Latin American countries are becoming more open they still have significant foreign ownership and a rent-generating political and economic structure, so that some rents, especially from extracting natural resources, may flow to multinational investors (Clausing 2012, 2013).[17] If owners rather than workers or consumers pay all or most of the

[17] Gravelle (2013) generally supports Clausing's argument that much of the U.S. corporate tax is borne by owners; however, other papers in the same journal argue that varying proportions of the tax may be borne by labor.

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corporate income tax, then tax incidence studies in Latin America may understate (or – perhaps – overstate) the progressivity of the tax system.[18]

In contrast to Latin American countries, the United States relies much more on revenues from the individual income tax and payroll taxes than on revenue from the corporate income tax and taxes on consumption (sales and excise taxes). While the basic contours of the U.S. tax system remain relatively unchanged, the relative tax burden among income groups and the scope and types of activities subsidized under the tax system has altered. Over the last 20 years, the federal tax-to GDP ratio has decreased slightly in the United States, though still within the 16-18 percent range of the last 60 years. High-income taxpayers became so wealthy, however, that income tax rates could be reduced for everyone while still collecting roughly the same aggregate level of taxes. As a result, the federal tax burden on the middle class is now at a historic low owing to a combination of factors — pro-poor tax policy that removed the poor from the income tax rolls, changes in welfare policy leading to the Earned Income Tax Credit, a pro-family tax policy reducing the tax burden on middle class families, and a not-so-secret sauce easing the way for tax cuts on the wealthy.

Implications for the Fiscal Contract

Current spending programs throughout the Americas are not sustainable without substantial increases in tax revenue. Tax increases may well be required just to maintain current social spending programs. Supporting more robust programs will definitely require changing the existing fiscal contract.

Traditional public finance analysis assumes that the state is an autonomous entity that can decide what to do and then do it.[19] One approach, epitomized by the optimal tax literature (Boadway 2012), treats states as though they were (or should be) benevolent social welfare maximizers. On the other hand, the public choice approach considers those who control states to be self-interested actors (Brennan and Buchanan 1980). In essence, both approaches assume that

[18] Some scholars assume that most corporate taxes in Latin America are passed on to consumers in the form of increased prices (Aronson and Bergman 2012). However, no good studies exist on the incidence of the corporate income tax in any Latin American country. Barreix, Roca and Villela (2008), recognizing this, simply leave the corporate income tax out of their analysis, as do Breceda, Rigolini and Saavedra (2009), an earlier version of which is the source of the estimates in Goni, Lopez and Serven (2008). Although we have not reviewed all the studies relied on by Lustig et al. (2011) and Mahon (2012), the importance of corporate tax revenues in Latin American tax structures (Jimenez, Gomez-Sabaini, and Podesta 2006) and the uncertainty of the incidence of the corporate income tax suggest that conclusions about the distributional effect of increasing 'income taxes' in Latin American countries are at best tentative. A recent study of Chile by Fairfield and Jorratt (2013) which adjusts household income data to attribute most undistributed profits to the top income group, underlines the complex interdependency between what one assumes about who gets the income and pays the taxes and measures of tax progressivity.

[19] An important variant of this approach is to assume that the state is not an actor in itself but simply the instrument of specific groups: social classes (Marxism), organized interest groups (Olson 1965), or partisan political parties (Hibbs 1977). These groups act in a self-interested way to increase their command over resources. In all these cases, however, it is usually assumed that those who control the state can use its power as they wish.

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"people pay taxes because they must; there is no relationship between the source of state revenue and state output; and spending is a function of rulers' whims (Timmons, 2005, 534)."[20] Such views stand in contrast to what Timmons (2005) calls the 'fiscal contract paradigm,' which assumes that governments are viewed as selling citizens services for revenue and hence, like good businessmen, most likely to respond primarily to the wishes of those who pay.

In contrast to Timmons (2005), we picture not the state negotiating with citizens for tax revenue but rather different interest groups negotiating among themselves to determine the level and quality of collective government goods and services and the type of taxes and relative tax burdens to fund these expenditures. Neither view of fiscal contracting fits easily with the 'welfarist' view, which takes redistribution as a major goal of the fiscal system and concludes that taxes should be paid mainly by the rich and expenditures should mainly benefit the poor.[21] The fiscal contract view implies that those expected to pay most of the taxes are likely to receive most of the benefits, and that their willingness to pay is tied to the expectation of receiving benefits. These benefits may be direct, as in government-provided cash or services or indirect, as in increased political stability or providing funds to the poor on the condition that they act in ways taxpayers value: for example, by ensuring that their children become educated. Discussions of taxation and inequality frequently focus on only two groups: the 'rich' (say, the top quintile, or even the top 1 percent) and the 'poor' (say, the bottom two quintiles). However, in the real world of the Americas, the most critical element may be how the 'middle' or 'upper middle' (say, the bulk of the population between the 'poor' and the top 1-2 percent) perceive themselves to be treated. [22]

A reasonable assumption for many countries is that the poor want some package of basic public services (in addition to jobs), while the rich seek mainly to keep what they have: that is, protection for their property rights. The poor mainly want service; the rich mainly want protection. To the extent that the middle class wants both service and protection, its recent rise in Latin America may help explain the apparently changing fiscal contract. In countries in which both growth and democracy have recently flourished, the changes in political equilibrium may alter the nature of the implicit fiscal contract underlying political stability and state legitimacy. The expanding middle class discussed by Ferreira et al. (2013), cannot easily emulate either the rich, who largely not only pay as little as possible in taxes but also make little use of public services, or the poor, who neither pay much nor benefit much. The middle class, and especially the vulnerable middle class, need a stronger public sector to secure their position as much as the

[20] This statement is obviously too sweeping, because there is a vast literature on tax evasion and compliance and on the effects of taxation on output. Nonetheless, it captures the flavor of much of the tax policy literature.

[21] Aronson and Bergman (2012) offer an interesting example of the implicit acceptance of the welfarist approach where they note that part of the failure of Mexico to introduce major tax reforms may be blamed on what they refer to as the "ideological principle" of the benefit approach. (Several possible alternative explanations are noted in the text below).

[22] Others have emphasized different versions of the fiscal contract approach when discussing recent and possible future developments in Latin America: see, for instance, Mahon (2011, 2012), Cornia, Gomez-Sabaini and Martorano (2012) and ECLAC (2013).

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poor need it to improve their position. At the same time, the middle class have fewer opportunities than the rich to opt out of the tax system by hiding wealth or shifting activities offshore. For the first time, a significant proportion of Latin America's population are now both politically relevant citizens and taxpayers, although they are not often fully aware of how much they pay and hence less concerned than they should be about how their funds are spent. As more people become aware (e.g. through expansion of more visible taxes on personal income and property) of the taxes they pay and of the extent to which their well-being and the future of their children depend on good state services, the political balance underlying the fiscal contract may change.

Taxation in the fiscal contract

One side of a fiscal contract is the tax system. Most political scientists consider income taxes a good proxy for taxes on the rich, and consumption taxes an equally good proxy for taxes on the poor (Kato 2003). Although this approximation is at best rough, it is true that most income taxes are paid by those in the top part of the income distribution. On the other hand, much depends on the structure of the personal income tax. Such taxes may, for example, impact relatively most heavily those who have just entered the tax system from the bottom — the lower middle class, who may for the first time have moderate levels of income and some property to protect. Higher tax burdens faced by the expanding middle class may reinforce the normal anti-income tax sentiment of the rich, a phenomenon that may become more important as income tax rate structures become flatter. As Table 7 shows, the income level at which Latin Americans begin to pay personal income tax is generally much higher than in developed countries.[23] In Mexico, for example, the personal income tax does not apply to workers with below-average wages, while in the U.S. and Canada the threshold is set much lower, at around 30 percent of the average wage (OECD 2012b). Similarly, the highest rates of the income tax also apply at much higher levels in many Latin American countries as compared to OECD countries.

[23] For an interesting further discussion, see ECLAC (2013).

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Table 7. Personal Income Taxes: Thresholds and Income at Maximum Rate

(as multiple of average per capita income in 2010).

Country	Threshold	Maximum
Argentina	0.30	3.66
Brazil	1.10	2.74
Colombia	2.83	10.65
Mexico	0.49	3.39
Peru	1.69	14.69
Average Latin America	1.41	9.06
Average OECD	0.24	2.38

Source and Notes: Lora (2012); 'threshold' is the minimum income level at which personal income tax has to be paid and 'maximum' is the income level at which the highest tax rate is applied.

So long as the absolute income level of the emerging middle class increases, the proportion of citizens paying income taxes is likely to grow. In Brazil, for example, a combination of increases in income, formalization of employment, and strengthened tax administration resulted in over 50 percent of those declaring income in 2011 paying income tax, compared to only 36 percent a decade earlier.[24] Many of those now caught in the tax net would seem to be natural allies of the poor, in the sense that both groups tend to want expansion of public sector services like health, education, pensions, and basic infrastructure services like transit, water, and sewerage.

Although total taxes and income taxes in particular are not that high in most of Latin America and tax systems are not progressive,[25] the extreme inequality of the region means that the rich nonetheless pay a relatively large share of taxes, so that simply increasing the net fiscal pressure on them may place additional strain on the fiscal contract. Tax reform in Latin America certainly does not require governments to give more fiscal benefits to the rich, and it may, appropriately, be accompanied by steps to remove some existing tax expenditures and such unwarranted gains on the spending side as virtually free tertiary education, in addition to rectifying severe legislative malapportionment that makes it easy for elites to block tax changes (Ardanaz and Scartascini 2011). Still, achieving significant tax reform may require assuring those who will have to pay more that, in return, their property rights and positions will be more secure than if the present inequalities were perpetuated. As Sanchez (2011, 36) said about the Chilean reform of the 1990s,"…entrepreneurs agreed to pay more taxes because the new government went to great lengths (in rhetoric and actions) to reassure them that it would maintain a vocation for free markets and an open economy." The new *Concertación* government was able to negotiate both a

[24] http://www.pulsamerica.co.uk/2013/02/25/brazil-over-12-million-currently-pay-income-tax/

[25] See Table 6, as well as further discussion in ECLAC (2013) and Wang and Caminada (2011).

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combined tax and social policy reform, which brought about political peace and the beginning of a move towards a new and, so far, lasting political equilibrium (Boylan 1996).

Even Colombia, often seen as a distributive laggard in the region (Moller 2012), may also be moving down this path. As Flores-Machias (2012) points out, since 2002 Colombia has imposed a tax on wealth, currently applying at rates of 2.4 percent of total liquid assets over USD 1.3 million and 4.8 percent on assets over USD2.5 million. Revenues from this tax are significant, fluctuating between 2.5 and 5 percent of government revenue and sometimes amounting to as much as 1 percent of GDP. How was Colombia able to do this? Essentially, by making a 'soft' but credible fiscal contract with the rich to earmark all the proceeds of this tax to security (financing an increase of about 25 percent in such expenditures) with the explicit objective of expanding the control of the national government over the entire country and improving the security of both persons and business investments – all objectives towards which considerable and perceptible progress was made. Some years ago, Bird (1992) suggested that countries in crisis can adopt reforms long considered impossible. Fairfield (2010), referring to the Chilean case, suggests that elite solidarity is easier to mobilize behind such reforms when a right-of-center administration is in power, because spending commitments will be more credible. Colombia in the first decade of this century satisfied both of these conditions. On the other hand, to achieve acceptance of the wealth tax, the government deliberately backed away from attempting more fundamental tax reforms that business interests opposed.[26] It remains unclear whether Colombia will follow countries like Brazil, Mexico and Chile in combining a slightly more redistributive tax policy with a more effectively redistributive social spending policy.

Roberts (2012) stresses the traditional argument that the shift to more 'leftist' governments is a principal reason for the recent change in distributive policy in Latin America. He notes, however, that there has been no apparent shift in ideological views and that even non-left governments moved in the same direction. As Colombia illustrates to some extent, what Hart (2010) calls the 'pro-market Right' is sometimes able to extract more tax revenue more efficiently, with less damage to both equity and growth, than the 'interventionist Left.' One reason is that the VAT, so often opposed fiercely by the Left, is a more effective and efficient way to tax than the income tax, a point well accepted by European social democratic governments (Lindert 2004). Perhaps optimistically, Colombia may also illustrate the argument made (in a different context) by Bodea and LeBas (2013) that when the provision of public goods through 'clubs' becomes less effective in conflict-prone communities, support for tax-financed public sector provision may increase. Since Latin Americans tend to be more concerned about inequality when worried about crime (Morgan and Kelly 2010), instability in personal life may lead to more attention to the need for a more stable community life.

Sustainability in the face of change

[26] See, for example, the reforms proposed by Bird, Poterba and Slemrod (2005) as well as Moller (2012).

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A sustainable tax system can be defined as one that is sufficiently aligned with prevailing economic and political factors to persist without requiring repeated major reforms. Achieving such a sustainable system requires striking the right balance between the equity and efficiency aspects of taxation in terms of political equilibrium. Any state that wishes both to grow and to implement redistributive fiscal policies (regardless of how much redistribution is desired) must first establish an administrable and efficient tax system. For such a system to be politically sustainable in any but a totalitarian setting, it must also be considered acceptably fair by a majority of the politically relevant population.

One reason Latin America long had tax systems that were neither efficient nor fair was likely because the politically relevant domain of the fiscal system was considerably smaller than the population as a whole. Increasing democracy in Latin America in the 1990s initially had little effect on taxation because of the combination of democratic institutions being either captured by the elite or undermined by short-sighted populism and the extreme weakness of state institutional capacity, particularly with respect to fiscal matters (Profeta and Scabrosetti 2008). However, the recent growth of the middle class has increased mobility across income classes and brought more people in direct contact with the tax system, thus raising the political salience of fiscal issues and increasing the importance of having a system perceived as both fair and growth-oriented (Daude and Melguizo 2010). Fortunately, as discussed below, tax institutional capacity has been substantially strengthened in most countries in recent years.

In contrast, over the same period, the increasing concentration of wealth and income at the highest levels in the United States and the removal of a large percentage of the population from the income tax rolls (Burman and Slemrod 2013) has, by reducing the direct contact of many Americans with the tax system, arguably increased the influence of the wealthy over the structure and level of taxation.

More democratic and sustainable outcomes cannot be induced simply by improving fiscal institutions, because a more encompassing and legitimate state is itself the key ingredient needed for a more balanced and sustainable tax system (Brautigam, Fjeldstad, and Moore 2007). Countries with similar economic characteristics in similar economic conditions can and do sustain very different tax levels and structures, reflecting their different political characteristics and the capacity of the state to deliver services and collect taxes. Economic structures and circumstances clearly influence tax levels and structures, but politics generally rules in shaping the final outcome. The fiscal reality of most countries reflects less evidence-based decision-making or empirical realities than a changing mixture of ideas, interests, and institutions. Tax systems are seldom planned.[27] Instead, they accumulate from incremental decisions over time and, like other political constructs, reflect the nature of the basic social norms binding different groups within national boundaries as influenced by both the changing local environment (e.g.

[27] History seldom supports the case for an 'intelligent designer' of the tax system. See, for example, the story told in Bank (2010) of how a long series of erratic changes over time led to the evolution of the current U.S. corporate income tax regime.

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democracy in its various forms) and the changing external context (e.g. globalization in its various aspects).[28]

Observations and Conclusions

Consider how the western democracies first got into the business of progressive taxation. In the United States, as Weisman (2002, 366) shows, over the course of prolonged discussions from 1860 to 1920, "economic crises and wars helped create a consensus for an income tax that falls most heavily on the wealthiest taxpayers." This lengthy debate about taxes was not so much about tax policy as about what kind of society Americans wanted. This consensus, a sort of fiscal contract, lasted until about 1970. Since then ideas about the balance between taxes and society have again been in flux in the U.S. In particular, progressive taxation appears to have lost much of its political appeal (Blyth 2000).

Balancing Equity and Efficiency

Other countries have reached different compromises. Alesina and Angeletos (2005) suggest, for example, that two models of redistributive taxation exist in developed countries. At one position is the United States, with relatively low taxes and low redistribution, while at the other are countries like Sweden, with high taxes and high redistribution. They attribute the difference to, essentially, self-fulfilling expectations. In the United States, they argue, it is believed that effort is causally related to income, so that those who make the effort, and consequently receive the income, are entitled to retain a large share of the fruits of their efforts. In the terms used by Musgrave and Musgrave (1989), the "entitlement" view is strongly entrenched in the United States. The unequal distribution of income is considered fair because it is believed to significantly reflect differential effort. Because tax rates are low, so are tax distortions, with the result that high effort may yield high after-tax income.

In contrast, Alesina and Angeletos (2005) suggest that in many European countries, the pervasive belief is that high income reflects not so much high effort as good connections or even corruption. Because the high taxes resulting in part from this belief system substantially reduce after-tax income, the connection between high effort and high income is greatly weakened, reinforcing the belief. Interestingly, however, perhaps reflecting the surprisingly good economic results discussed earlier, it appears that Mexicans and Brazilians are now almost as convinced as Americans that hard work is the most important factor in achieving financial success.[29]

[28] The importance and persistence of national and regional social and cultural norms is emphasized by Inglehart and Welzel (2010) and, in a different way, by Acemoglu and Robinson (2011).

[29] http://www.pewglobal.org/question-search/?qid=1458&cntIDs=@2-@6-@6.50-@8-@32-@38-@50-&stdIDs=@201201

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Most high-tax countries have substantially blunted the disincentive effect of taxation by lowering tax rates and favoring investment activities (Lindert 2004). Modern democratic states tend to gravitate towards either a big government approach combining redistributive expenditures with not very progressive taxes (Sweden) or a small government approach pairing more progressive taxes with less redistributive expenditures (the United States). The implications of choosing a larger and more redistributive public sector for tax policy are not necessarily what one might expect. Although tax policy choices can be more damaging the larger the government share of economic activity, most big government countries have more pro-growth (and less progressive) tax structures with lower effective tax rates on capital income, lower property taxes, and relatively higher taxes on labor income and consumption (especially on socially damaging activities such as smoking, drinking, and environmental damage). On the other hand, countries like the United States with smaller government sectors tend to have higher taxes on capital and wages and lower taxes on consumption, placing relatively more of the tax burden on more elastic factor supplies, with consequently more damaging effects on resource allocation and growth. It is not surprising to find that the income tax in the United States has long been much more progressive than that in Sweden (Steinmo 1993) and remains one of the most progressive in the world (OECD 2008).

The search for a sustainable fiscal contract is a continuous process in every country. For years in many Latin American countries, no viable democratic social consensus with the right balance between equity and efficiency in taxation seemed attainable. Many countries in the region were (and some still are) far from being perfect democracies (Snyder and Samuels 2001), being better characterized as "democratically exploitative" states — states in which those in power use it largely for self-aggrandizement or to support particular groups or interests. The rise of the middle class has clearly contributed to democratization in many Latin American countries in recent years (Ferreira et al. 2013), but this does not imply that every country in this heterogeneous region will reach similar fiscal contracts. What is right, or at least feasible, in Chile or Brazil may be neither desirable nor possible in Colombia or Honduras.

Taxation is one of the few ways in which the wealthy may be made less wealthy, short of outright confiscation. Although attempts to redistribute income through taxation have not been markedly effective anywhere (Bird and Zolt 2005), as even rich countries have learned in recent years it may nonetheless be important politically to impose highly visible taxes on those who gain the most. Sustainable tax policy needs to be accepted as fair by most people in a democracy. The real question is clearly political: can the obvious opposition of the wealthy elite to such taxes be overcome? The wealthy can block such efforts in many ways: they can block progressive legislation from being passed (Ardanaz and Scartascini 2011); they can introduce incentives and provisions to blunt its effects (often allegedly in the name of the "national interest"); they can corrupt the administrative process; they can use their resources to mute and delay it in legal

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ways; or they and their resources can leave the jurisdiction. All this and more happens in most Latin American countries, and has for many years (Gomez Sabaini and Jimenez 2012).[30]

The political reality in most countries, the opening of capital markets, and weak international tax enforcement capabilities make it harder to tax the wealthy. Countries tend to have the tax systems that those who run them want, and those who ran many Latin American countries did not favor a very redistributive tax system. However, the increasing importance of the middle class and the interest of both the rich and the middle class in securing what they have, even if one price for doing so is to pay more taxes in part to help redistribution efforts, may have begun to alter the political balance and the nature of the fiscal contract in some countries.

The central social and economic problem in many Latin American countries remains inequality. Another problem is the lack of government accountability. A good tax system is critical to solving both problems. An important factor shaping the nature of the fiscal contract is the cost of tax collection. Gordon and Li (2009) and Kenney and Winer (2006) emphasize, in different ways, that when economic and technological changes alter the relative costs of imposing taxes, both tax structures and tax levels adjust. The widespread adoption of the VAT has played a central role in improving tax administration effectiveness in Latin America, because the successful implementation of this tax usually requires a substantial upgrading of the capacity to administer taxes (Mahon 2011). The adoption of the (very imperfect) Brazilian state VAT had the important result of strengthening both accountability within the public sector and the degree of trust between taxpayers and tax officials (Pinhanez 2008). Provided the political will exists to increase tax revenues, the improvement made to administrative capacities by adopting a VAT makes it more feasible to reform other parts of the tax system.

It is easy to think of ways to tax the rich more effectively through indirect means such as taxes on vehicles as well as through direct taxes on income and wealth (land, estates). To the extent that some income of the rich reflects "rents" secured through political connections or monopolies, such taxation may not even give rise to distortionary costs. On the other hand, attempts to impose undue redistributive taxes may backfire, resulting in smaller and less redistributive public sectors (IDB 1998), and even the most redistributive taxes may have little effect on income redistribution (Harberger 2006). From the perspective of redressing income inequality and poverty, the most important function of the tax system is not to punish the rich, but to provide funding for pro-poor (or at least not 'pro-rich') spending programs.

The dominant policy ideas in different countries (such as equity, efficiency, and growth), like the dominant economic and social interests (such as capital, labor, regional, ethnic group, rich, and poor) and the key political institutions (democracy, decentralization, budgetary), and economic institutions (free trade, protectionism, macroeconomic policy, and market structure) all interact in tax policy formulation and implementation. Taxation – its level, structure, and administration

[30] Similar pressures are also at work in developed countries, as Graetz and Shapiro (2006) show with respect to the estate tax in the United States.

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— is one of the major battlegrounds on which we can observe the interaction of these complex forces over time.

Only recently have some Latin American countries begun to undergo the evolutionary process that produced the (more or less) redistributive fiscal state now found in most developed countries. A long preparatory period seems needed for the desirability, and perhaps necessity, of a more effectively progressive fiscal system to become sufficiently established. Governments in many Latin American countries have struggled both economically and politically. Even those with some degree of political legitimacy and stability have faced substantial constraints on fiscal policy. Until an adequate degree of political consensus on what should be done is achieved, significant tax changes are unlikely to be made. As Lledo, Schneider, and Moore (2003, 47) noted, the problem in Latin America for many years was that most countries lacked "…an (implicit) social contract between governments and the general populace of the kind that is embedded in taxation and fiscal principles and practices in politically more stable parts of the world." Over the last decade, some changes have begun to emerge as economic growth creates a larger and more empowered middle class, leading both to greater economic mobility and more robust democratic governments (Ferreira et al. 2013). On the other hand, some observers in the United States have recently expressed considerable concern about the apparent fracturing of the American social contract in recent decades (Roemer 2011), as reflected in the bitter and unresolved battles taking place over the size and structure of taxation and expenditure (Bargain et al, 2013).[31]

Lessons to be Learned

What lessons may be drawn from the divergent experiences of Latin America and the United States with respect to the design, redistributive effect, and effectiveness of tax policy and the appropriate role of the fiscal system in achieving an environment conducive both to economic growth and to the development of a stable and sustainable political system?

Had Latin American countries adopted the common 1960s prescription for much heavier reliance on income taxes in tax regime design (Bird 2012), would they be better or worse off than they are now? If the U.S. had followed the rest of the world and adopted a national VAT some years ago, would it be better or worse off? Arguably, Latin America is better off for having ignored the conventional wisdom and adopted the VAT route, partially because the stronger tax administrations that resulted from following this less conflict-prone path may now permit stronger income taxes. On the other hand, the United States would likely have been better off adopting a VAT years ago, since relying less heavily on income taxation to solve its fiscal problems would probably have improved its competitive position and reduced the continuing political struggle over taxation.

[31] For more detailed discussion of recent United States experience, see Stark and Zolt (2013) and Zolt (2013).

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Social spending and taxation structures in Latin America are closer to those in the United States than in Europe. Noting this, Brededa, Rigolini and Saavedra (2009) suggest that the underlying fiscal contracts in the U.S. and Latin America may be converging because both derive most of their tax revenues from the wealthy, a group that gets little from state social spending in return. In contrast to the more inclusive (and more redistributive) models found in Europe and even in Canada, the result, they suggest, may be a more minimalist welfare state in both the United States and in Latin America.[32]

To the extent that Latin American attitudes and social norms are closer to those in North America than in northern Europe this conclusion receives some support. However, if a stronger welfare state proves necessary to maintain a country's socio-economic stability, the overlapping economic and political elites dominating most Latin American countries may have to make the choice (familiar from European fiscal history) between prolonged, possibly violent political confrontations on redistributive issues, or continuing to reshape formal political democracy into a more socially inclusive process of development of the underlying social (and fiscal) contract.[33]

The poor have little choice but to rely on public services, no matter how scanty or low-quality they may be. In some countries, the emerging middle class may have the choice of focusing on improving the social security system with respect to health and pensions. In all countries, however, they must choose whether to educate their children in the public system or in the generally better private system now utilized largely by the wealthy and upper-middle class. The public sector may finance such access to private education, as is done to some extent in Chile and Colombia, just as it may make the social insurance system more equitable and efficient. These alternatives, like the straightforward extension of access to (and improvement of the quality of) the public sector, will cost money and require additional tax revenue. The conundrum facing Latin American policy makers is whether to focus on expanding and improving traditional public sector services or on providing increased access for more people to alternatives available from private providers. If the latter approach can deliver perceptible benefits to more people, it may increase their willingness to support tax increases needed to finance expanded public sector social spending. Many Latin American countries have already decentralized public sector provisions, primarily to better match public services with the wishes and needs of local communities (Brosio and Jimenez 2012). The emerging welfare state may end up more like the smaller American model than the European one, but it would still be a major improvement for many Latin American countries.

[32] Breceda, Rigolini and Saavedra (2009, 722) exclude pensions from their analysis because it is "difficult to assess their redistributive nature" owing to their inter-temporal dimension and the mix of financing. Although it is not that hard to disentangle the financing (as Bird and Smart (2013) do for Latin America), this omission makes little difference to their argument since public pensions in Latin America go largely to the middle class, although financed in many countries to a significant extent from general revenues.

[33] For discussions of the paths traced by the 'fiscal sociology' of different countries, see, for example, the studies in Martin, Malhotra, and Prasad (2009).

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In both the United States and Latin America, a new fiscal contract might include less progressive taxes to support more progressive spending programs. Tax changes increasing the tax burden on the wealthy are no doubt often justifiable and may sometimes be necessary. But achieving the political support and revenue needed to fund additional social spending programs benefiting both the poor and middle class will likely require increasing tax burdens on non-wealthy groups as well.

An obvious answer to the fiscal dilemma arising from the combination of increased political pressure for more services and less political support for income taxes is to rely more heavily on consumption taxes. Consumption taxes generally impose a relatively larger burden on lower than on higher income groups, but they are paid much more by the middle class than by the poor.[34] In the United States, where the distribution of tax expenditures is skewed towards upper and upper-middle income-earners (those who pay the bulk of the income tax), recalibrating the fiscal balance between expenditures and revenues may prove more difficult than in Latin American countries. The wealthy in Latin America, as is also increasingly true in the United States, are basically outside the public service delivery system, which does not augur well for the future sustainability of either fiscal contract unless a greater effort is devoted to creating a consensus in terms of social norms and the acceptance of national political goals (Alesina and Reich 2013). Countries can maintain or increase state capacity to collect tax revenues only if taxpayers believe that the funds will be spent wisely– that is, in ways that they perceive as benefiting them directly (by providing public services) or indirectly (by strengthening a sustainable legal and political framework to support property rights). How well North and South America will be able to manage the difficult task of restructuring their 'fiscal contracts' in the years to come remains to be seen.

[34]Although at present consumption taxes in many countries still impose a heavy and undesirable burden on the poor, it is not difficult to design and implement fairer taxes. A recent proposal by Barreix, Bes and Roca (2010) suggests a broad-based VAT with an offsetting credit for lower income groups. Unlike the similar system in Canada, where the credit is administered through the income tax, they suggest that in Latin America it could be administered in the same way as are the conditional cash transfer systems already in place in several countries.

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