TAX REFORM IN LATIN AMERICA:
A Review of Some Recent Experiences*

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Not since the heyday of foreign tax missions in the 1960s has tax reform been discussed as intensively in Latin America.[1] During the 1980s, major tax reforms took place in Mexico, Bolivia, Argentina, and Colombia, and somewhat similar reforms occurred in the previous decade in Chile and Uruguay. Moreover, tax reform seems to be climbing higher on the policy agenda in countries as diverse as Guatemala, Venezuela, Paraguay, and Peru.

No brief article can describe comprehensively the nature and significance of the diverse tax changes that have occurred recently for different reasons in different countries. Indeed, in view of the heterogeneity of tax-reform experience in Latin America, attempting such a task might prove neither feasible nor useful.[2] The objective of this article is much more modest. It will describe the key features of recent major tax reforms in Bolivia, Argentina, Mexico, and Colombia, paying particular attention to the largely successful Bolivian reform of 1986. These four countries have been chosen for examination because their diverse experiences offer useful general lessons for would-be "tax reform-mongers" (to use Albert Hirschman's evocative description) in other countries.[3]

*An earlier version of this paper was prepared in 1989 for the Economic Development Institute of the World Bank. I am grateful to Charles McLure, Wayne Thirsk, and several anonymous *LARR* referees for their helpful comments. I alone, however, am responsible for what is said here.

1. The most important tax studies in earlier periods were those headed by Shoup (1959, 1965), Musgrave (1971, 1981), and Taylor (1964, 1965, 1969). See also the important conference volumes sponsored by the Organization of American States and the Inter-American Development Bank (OAS Joint Tax Program 1965a, 1965b; and OAS 1973). Tax reform in Latin America until the late 1960s was summarized and appraised in Bird and Oldman (1968); see also Andic and Peacock (1966) and Sommerfeld (1966).

2. In particular, no attempt is made in this article to comment on tax reform in Brazil or the Caribbean region. See Bahl (1989) on important recent reforms in Jamaica.

3. To some extent, these "lessons" draw also on my much broader range of experience with tax reform efforts in Latin America and elsewhere over the last twenty-five years. To keep the bibliography manageable, however, references to countries other than the four under discussion here have been largely confined to footnotes.

BACK FROM THE BRINK: TAX REFORM IN BOLIVIA[4]

Prior to the acute economic crisis of the early 1980s, Bolivia's tax system was fairly typical of a small, open low-income country (Musgrave 1981). It depended heavily on taxes on imports and exports, with each category accounting for about a third of tax revenues in the mid-1970s. Although Bolivia's personal income tax was in principle fairly comprehensive (for example, all capital gains were supposed to be taxed), in practice it amounted to little more than a tax on labor income in the modern sector. The nominal rate structure was progressive, with a top rate close to 50 percent, but liberal allowances and exclusions substantially reduced effective progressivity. A uniform "enterprise tax" of 30 percent was levied on net business income, irrespective of whether the business was organized as a corporation, partnership, or sole proprietorship, with a lower rate of 20 percent applied to state enterprises. Special rules existed for small businesses and natural resource companies.

Although a general sales tax in the form of a value-added tax (VAT) had been imposed in 1973 on a broad base that included capital goods at a rate of 5 percent, the number of rates and exemptions later increased. This tax, which was poorly enforced, met with widespread evasion and produced surprisingly little revenue.[5] Indeed, the traditional excise taxes on beer and tobacco levied at specific rates (per bottle or package rather than as a percentage of price like the VAT) produced more revenue than the 1973 VAT. Like many other countries, Bolivia also imposed a wide variety of other consumption taxes that produced little in the way of revenue.

The Bolivian tax system was thoroughly reviewed in 1976 by a fiscal mission headed by Richard Musgrave.[6] The Musgrave report (1981) identified the fragile foundations of the Bolivian revenue system and its extreme vulnerability to external shocks due to excessive dependence on revenues from taxes on foreign trade. The report urged that the domestic tax base be strengthened and broadened quickly and made a wide-

4. This account is based partly on unpublished materials prepared at different times by Laura Tuck, Jorge Ospina Sardi, Wayne Thirsk, and Carlos Silvani, as well as on Cabezas (1990) and Mann (1990). In addition, I have drawn on my own earlier experience in Bolivia, as reflected in Musgrave (1981).

5. A number of Latin American countries adopted what is generally considered to be the most modern form of sales tax—the value-added tax (VAT)—long before it was adopted by such European countries as Spain and Portugal (both 1986) or Greece (1987). They were led by Brazil in 1967 and include Bolivia (1973), Argentina (1975), Ecuador (1970), Uruguay (1970), Colombia (1975), Honduras (1976), Nicaragua (1975), Costa Rica (1975), Peru (1976), and Panama (1977). With the addition of Guatemala (1983), the Dominican Republic (1983), and Mexico (1980), only Venezuela and Paraguay remain virgin territory for a VAT policy among the Spanish-speaking countries, although many of the VATs already in operation could certainly benefit from reform, as noted for Argentina. While a full comparative study of Latin American experiences with VATs remains to be done, good general discussions may be found in Tait (1988) and Gillis, Shoup, and Sicat (1990).

6. Taxes on the mining sector were studied separately in Gillis et al. (1978).

https://doi.org/10.1017/S0023879100016599 Published online by Cambridge University Press

ranging series of recommendations for tax and budgetary reform. Unfortunately, this warning was ignored. The crisis came and the system collapsed.[7]

Crisis and Reform

The export boom of the 1970s that masked the fundamental weakness of Bolivia's revenue structure had encouraged an unsustainable expansion of government expenditure. When the world recession hit early in the 1980s and was exacerbated by substantially adverse weather conditions in the agricultural sector, both current revenues and Bolivian access to foreign capital fell sharply. The only way out was to borrow from the central bank—to "print money" in economic terms—with the predictable consequences of rising inflation, further declines in revenue, and still more inflation.

Bolivian revenues were hit particularly hard by inflation because of certain structural features of the tax system. Lagged collections of income taxes, together with poor penalty and enforcement systems, resulted in diminishing real collections from direct taxes, a phenomenon that earlier had been documented in detail for Argentina by Vito Tanzi (1977).[8] Moreover, heavy reliance on specific rates of excise taxes ensured that real tax yields would fall as price levels rose unless rates were constantly increased. The effects of the overvalued exchange rate on the real yield of the important foreign trade taxes reduced real indirect tax collections in a similar manner.[9]

The results were catastrophic. The tax revenues of the Bolivian central government fell from an average of 11 percent of gross domestic

7. Although the political instability of the day ensured that the recommendations of the Musgrave mission were never actively considered by the government, Cabezas notes that "Bolivians interested in fiscal matters have used that report extensively, and it was studied by members of the Bolivian tax reform commission that was established in late 1985" (Cabezas 1990, 532). In fact, a number of the Musgrave recommendations were implemented in the 1986 tax reform, including elimination of earmarked taxes, equal tax treatment of public and private enterprises, and a simplified tax system for small taxpayers. As in the case of Colombia, what foreign advisors do may thus endure long after they have departed. An even more dramatic illustration of the potentially long life of tax advice may be seen in the case of Venezuela. While little substantive tax reform has taken place at any time in Venezuela, the influence of the Shoup (1959) mission is evident in the 1983 report of the Comisión de Estudios y Reforma Fiscal (CERF 1983). This continuity is not surprising considering the fact that the same individual, Tomás Enrique Carrillo Batalla, was instrumental in involving Shoup in 1959 and subsequently became head of the later commission.

8. Because this phenomenon was earlier depicted by Argentine economist Juan Tanzi in Olivera (1967), it is often referred to as the "Olivera-Tanzi" effect.

9. Taxes were levied on import prices converted to pesos at the official exchange rate. Because this rate was only about one-third of that in the parallel market by 1984, the peso price for tax purposes was only about one-third of the actual selling price and real tax yields were correspondingly reduced.

product (GDP) in the 1970s to less than 3 percent in 1984.[10] At the same time, inflation was roaring ahead at an annual rate approaching 12,000 percent by 1985, and real levels of income and consumption were declining sharply.

The economic crisis demanded drastic changes in policies so clearly that the newly elected government of Víctor Paz Estenssoro, with surprisingly broad political support, was able to hurry through a series of substantial economic reforms that deregulated and liberalized a wide range of economic policies. These changes involved exchange rates, credit markets, and the labor market. Because the Bolivian economy had become "dollarized"—that is, the U.S. dollar rather than the Bolivian peso had essentially become the basic unit of account and store of value—and inflation had wiped out all long-term contracts, prices were so flexible that surprisingly few costs of adjustment were incurred in moving to the new economic regime.

A uniform tariff rate of 20 percent was also established, and domestic prices of hydrocarbons (such as gasoline) were raised to world levels. The latter move in particular increased government revenues substantially. Another key element in this "new economic policy" was a complete reform of the internal tax system in May 1986. The immediate effect of this package was to halt inflation dead (the annual rate of inflation was reduced to 14 percent by 1987) and to reduce the fiscal deficit, which had peaked at more than 30 percent of GDP in 1984, to less than 2 percent of GDP in 1986. Because most of the internal tax reforms did not take effect in 1987, however, their immediate contribution to this outcome was minor.

Much more significant were the greatly increased revenues from petroleum taxes, which accounted for more than half of central government current revenues in 1988 (Mann 1990). As Arthur Mann notes, however, the policy of keeping petroleum prices constant in U.S. dollar terms was dropped prior to the 1989 election, making continued strengthening and development of the new internal tax system even more crucial. As a percentage of gross national product (GNP), internal taxes rose from 1.3 percent in 1985 to 6.3 percent in 1988 and to 7.7 percent in 1989. At that point, customs duties accounted for 2.0 percent of GNP and petroleum taxes for 4.5 percent, yielding a total tax ratio of 14.2 percent (Cabezas 1990).[11]

Bolivia's remarkable achievement of increasing tax revenues from a low of 3 percent in 1983 and 1984 to 13 percent of GDP by 1986 and 17 percent in 1987 reflects three facts. First and probably most important, the

10. These figures come from Mann (1990). Other sources may show somewhat different numbers, but the trend is similar.

11. Somewhat different figures (on a GDP basis) appear in Mann (1990), but again the trends are basically similar.

situation in Bolivia had become so desperate that the characteristic Latin American modus vivendi that finds inflation more politically acceptable than taxation was no longer viable. All major political groups were, at least for a time, prepared to swallow the bitter medicine of tax reform. Second, the Bolivian government acted decisively with the explicit objective of restoring revenues and creating a more stable tax system. Third, most of the measures taken toward this end proved effective, thus restoring the necessary degree of confidence required for an economy to function effectively.

Before describing these measures briefly, however, two caveats should also be noted about the Bolivian experience. The first is that while runaway inflation was decisively halted, so was economic growth. Real GDP, which fell by 2.9 percent in 1986, rose only by an average of 2.5 percent in 1987 and 1988 (Mann 1990). The moral seems to be that once lost, economic stability can be regained only at a high price, an outcome that has been witnessed often in Latin America. The second caveat is that although traditional "equity" concerns were swept aside in the drive to restore revenues and create a workable tax system, it is far from clear whether concern for equity will not eventually erode the pristine simplicity of the present tax system, for better or worse. As Mann has noted, "there exists a gnawing sentiment that the tax structure is not progressive enough" (1990, 36). Up to the present, nevertheless, Bolivia's drastic "tax revolution" has withstood the test of time surprisingly well.

Taxes on Foreign Trade / The Bolivian tax reform had four major components: tariff reform, indirect tax reform, direct tax reform, and administrative reform. The single most important source of revenue before the crisis of the early 1980s was customs duties. In August 1986, the highly differentiated tariff (with rates as high as 150 percent) was replaced by a uniform tariff of 20 percent. In March 1988, it was reduced further to a uniform tariff of 10 percent.

As economists have argued for years in many parts of the world (usually to no avail), a uniform low tariff not only reduces often unwanted disparities in protection across different sectors but also lessens the reward for smuggling and the scope for corruption in customs administration. The Bolivian experience seems to be bearing out these predictions. The lower tariff rate was also consistent with the government's stated desire to reduce reliance on volatile trade taxes and shift the tax base from imports to domestic consumption. In 1988, for example, taxes on foreign trade yielded only 12 percent of central government revenues, compared with 20 percent or more in the early 1980s (Mann 1990).

Taxes on Domestic Consumption / The key to reforming domestic consumption taxes was imposing a 10 percent value-added tax on an extremely

https://doi.org/10.1017/S0023879100016599 Published online by Cambridge University Press

broad base, excluding only housing, financial services, and (unavoidably) transactions in informal markets.[12] The new VAT was supplemented by taxes on specific consumption items at rates of 30 percent on alcoholic beverages and perfumes and cosmetics, rising to 50 percent on tobacco and jewelry. The taxes on perfume, cosmetics, and jewelry seem questionable, however, given enforcement problems. In 1988 these taxes were altered in several ways: the tax on jewelry was reduced to 10 percent; the tax on beer was raised to 45 percent; a new 20 percent tax was imposed on soft drinks; and various electrical goods, pottery and china, and automobiles were also subjected to special excise taxes. Thus the original simplicity of the new consumption tax system is beginning to disappear.[13]

In addition and more surprising, the VAT was also supplemented by a new 1 percent "transactions tax." This tax (a modern-day revival of the ancient Spanish *alcabala*) is really a cumulative turnover tax. Unfortunately, it is subject to precisely the defects of "cascading"—the cumulation of taxes on intermediate goods in final product prices that are themselves taxed, the taxation of inputs to exports, and other defects—that the VAT form of sales tax was designed to eliminate (Tait 1988). This archaic form of sales tax in the Bolivian tax reform of 1986 was apparently introduced to provide a little additional revenue, along with information that might be useful in enforcing the value-added tax.[14]

Revenue was evidently the main rationale also behind another feature of the Bolivian tax reform that has attracted considerable attention abroad. A "complementary tax" was introduced under which all income (wages, salaries, rentals, interest, royalties, and so on) paid to individuals was subject to a 10 percent withholding tax. The base of this flat tax, however, is not total income from withheld sources. Four "minimum national salaries" (totaling approximately eighty U.S. dollars a month) may be deducted from monthly income. Moreover, individuals can offset

12. Another important change already mentioned was the increase in domestic petroleum prices, which raised tax collections from this source from 0.4 percent of GDP in 1984 to 6.5 percent in 1985 and 8.8 percent in 1988, more than the total yielded by the entire internal tax system (Mann 1990). The appropriate design of energy taxes, especially their adaptation to changing world prices, has also been a key fiscal factor in other countries in recent years. See, for example, the discussion of Argentina in World Bank (1990). Unfortunately, space precludes further discussion of this point, because oil taxation cannot be understood (even in non-oil-producing countries) without a full discussion of investment and pricing in the energy sector in general.

13. The phenomenon of a drastic policy simplification followed by gradually increasing complexity as the years and political necessities roll by, followed in the fullness of time by yet another drastic reform, is so commonly observed that some have suggested that what is really needed is a "cyclical" analysis of tax reform. In this context, the present article may perhaps be viewed as a first look at the current swing of the fiscal reform cycle in Latin America.

14. More commendably, the transactions tax was also applied to bequests and gifts in lieu of the previous death and gift tax. In 1987 an additional tax was levied on such gratuitous transfers, at a rate of 1 percent for transfers to spouses and descendants (and ascendants) and 10 to 20 percent on transfers to others (Cabezas 1990).

against this tax the value-added taxes they have paid, as verified by invoices. To the extent that they do so, the complementary tax effectively taxes savings (or that part of income not spent on items yielding VAT receipts) at the same rate as consumption.

The aim of the complementary tax thus was not just to provide revenue but to encourage people to acquire VAT receipts. Moreover, because in principle the government can add up the information received from individuals, firms would presumably be encouraged to remit the VAT they collect to the government.

It is far from clear, however, that this device boosts tax enforcement significantly. One reason is that the stimulus to collect receipts is weak, given the obvious alternative of making a deal with the merchant not to pay the VAT in the first place and splitting the difference. A second reason is that the government is unlikely to be in a position to do much with the information received as a result of this provision. Related schemes to encourage consumers to demand VAT receipts have long been tried in other countries (for example, in Chile) and have proved only marginally useful at best in enforcing VATs (Casanegra de Jantscher 1990). Even the much more advanced Korean system, which initially set out to check all invoices claimed for credit by purchasers against those reported by sellers, soon gave up the attempt as cost-ineffective (Choi 1984). Apart from a possible initial effect of scaring taxpayers into compliance, this particular tax gimmick seems unlikely to have played a major role in the resuscitation of the Bolivian tax system.

Moreover, the complementary tax contradicts the major economic thrust of the Bolivian reform, which was clearly to shift domestic taxation away from income and onto consumption. Viewed in the context of a reform that eliminated all direct taxes on income, the role of the complementary tax as a tax on savings seems as out of place as the transactions tax in the context of a value-added tax.

The New Direct Taxes / The unique and most startling aspect of the Bolivian reform was that both personal and enterprise income taxes described above were simply eliminated.[15] In their place, a trio of new taxes was created.

In the first place, all owners of real estate and vehicles were subjected to a progressive tax (to be shared with municipalities) at rates ranging from 1.5 percent to 5 percent on vehicles and from 1.5 percent to 3

15. Although Uruguay had eliminated its personal income tax much earlier (in 1975), that tax was more recently established and less important in revenue terms than in the case of Bolivia. Moreover, Uruguay retained substantial income taxes on business and agricultural income (at least in principle) as well as heavy payroll taxes on wages and salaries (Harberger 1989).

https://doi.org/10.1017/S0023879100016599 Published online by Cambridge University Press

percent on urban real estate, rates varying according to value. These rates would be high if the values were adequately assessed, but the efficacy of such taxes (like their predecessors, vehicle and urban property taxes) depends entirely on the effectiveness of the automobile registration system and on how up-to-date property values are.[16] The similar tax established for rural property, based on the land's potential yield and the nature of farming in the region, seems likely to prove too complex to amount to much in Bolivian circumstances.[17]

The enterprise income tax was similarly replaced (except for cooperatives and natural resource companies) by a 2 percent tax, increased to 2.5 percent in 1988, on the net worth of public and private enterprises alike. Taxes on vehicles and real estate owned by enterprises can be credited against this tax. A major consequence of abolishing the enterprise income tax was that the array of investment incentives that had proliferated in Bolivia in the early 1980s have all vanished (although established firms benefiting from such incentives are still exempted from the new assets tax). Bolivia has thus joined Indonesia in becoming one of the few countries to have made a clean sweep of tax incentives (Gillis 1985).[18]

The efficacy and effects of the new business net-worth tax again depend largely on how well it is administered in such areas as detecting fraudulent debts used to reduce net worth. A similar tax has been used with considerable success in Colombia for many years (McLure et al. 1989), but with the key difference that it serves not as *the* tax on business income but rather as a minimum tax.[19]

16. Cabezas asserts that the "self-appraisal" guidelines developed for real estate and vehicles have raised taxes substantially and cites his own experience to prove the point (1990, 536). I am sure Ramiro Cabezas, an honest man and the key figure in implementing the Bolivian tax reform, indeed complies fully with the law. I doubt very much, however, that the system will work equally well with less scrupulous taxpayers. For a brief critique of similar "self-appraisal" systems elsewhere, see Bird (1984a).

17. Again, Uruguay may appear to afford a precedent in view of its innovative presumptive tax on agricultural income based on the potential productivity of the soil. But in fact, as noted by Harberger (1989), this fairly crude tax device is now optional for smaller farmers and is supplemented for larger farmers by a tax on actual income from agriculture. Moreover, even if Uruguay could implement such a tax, it seems unlikely that Bolivia could or should attempt to do so. As Bird (1974) demonstrates in detail, if a poor country like Bolivia wants to tax its agricultural land, it is well advised to do so in as simple a manner as possible. The proposed Bolivian rural land tax does not appear to satisfy this criterion and would likely prove as much a failure in practice as the many similarly complex schemes in other countries described in Bird (1974) and Strasma et al. (1987), excerpted in Bird and Oldman (1990).

18. As will be noted, the effect of such incentives in eroding fiscal revenues and complicating tax administration is especially marked in Argentina.

19. While the close relationship in many Latin American countries between local and national taxes is another topic that cannot be adequately discussed here, it is interesting to note that, as in Bolivia, the (municipal) real property tax was made creditable against the net-wealth tax in Colombia in 1984. An unexpected consequence of explicitly linking these two conceptually quite different taxes ensued in 1989, when the Colombian net-wealth tax was

The final component of the new set of "direct taxes" derives from the Musgrave report (1981). A "simplified tax" was imposed on very small enterprises (in both capital and sales) to replace not only the enterprise net-worth tax but all other taxes payable by such enterprises (for example, the VAT). Basically, the simplified tax consists of a fixed (lump-sum) amount determined according to self-declared revenue from gross sales. Clearly, the effects of this tax too will depend entirely on administrative success in ensuring that these declarations accord at least roughly with reality and especially in preventing larger firms from fraudulently sheltering themselves (through artificial fragmentation) within the haven of the "simplified tax."

Administrative Reform / All the new direct taxes introduced in Bolivia's 1986 reform thus depend on precisely the kind of good tax administration that Bolivia has long lacked. As a result, the important changes in tax administration accompanying the reform of tax structure are central in explaining the relative success of the Bolivian reform.

The first such change, perhaps more valuable in symbolic than in real terms, was the creation of the new Ministerio de Recaudaciones. Tax collection was removed from the Ministerio de Hacienda, restructured, restaffed, and given new status by raising it to ministerial level. After the immediate crisis subsided, however, this office was reincorporated into the Ministry of Finance in 1988.

A second major administrative reform was accomplished by eliminating a number of small taxes[20] and simplifying the administration of direct taxes considerably. This goal was achieved by redesigning the tax structure to eliminate such difficult tasks as assessing business profits or applying a progressive personal tax on a comprehensive income base.

A third important administrative action launched a surprisingly successful registration campaign for new taxpayers, something that had really never been tried before in Bolivia. The number of registered business taxpayers doubled, although it is not clear what the revenue effects of this increase were or whether the new information is being effectively used.

The final two administrative changes were undoubtedly the most significant from the perspective of revenue. First, substantial efforts were made to strengthen tax enforcement, especially in La Paz, the capital and largest city. In particular, a special office was created to keep a close check

effectively abolished after more than fifty years of relatively successful existence, apparently as a result of strong protests that had arisen from a botched attempt to revalue real property in Bogotá.

20. Perhaps the most notable Latin American experience along these lines was the 1975 elimination of some 130 small taxes in Uruguay and somewhat similar changes in Chile in the same year (Harberger 1989).

https://doi.org/10.1017/S0023879100016599 Published online by Cambridge University Press

on the largest and most important taxpayers; penalties (and interest penalties for late payment) were strengthened; computers were employed increasingly to monitor taxpayers; and (most striking of all, given Bolivia's dismal record in this regard) some establishments were actually closed for failure to issue proper VAT receipts. The idea that the tax administration now has some idea of what is going on, at least in a major part of the economy, and can penalize noncompliers is something totally new in Bolivia. This realization appears to have had a healthy effect in stimulating compliance.[21]

The last major administrative change turned over tax collection to the commercial banks. Bolivian banks now receive both tax payments and tax returns. They are responsible for sending the taxes collected to the treasury (or in the case of the municipal share, to the local authorities) and for supplying data to the tax data center. In exchange, the banks are allowed to keep 0.8 percent of the revenues they collect. Although some delays continue to occur at both ends in processing the information thus transmitted, this system undoubtedly provides better control over both revenue and data than the one in place before the reform. Equally important, the new system has the virtue of minimizing direct connections between tax officials and taxpayers, substantially reducing the opportunity for corruption.

An Assessment

Although more time must pass before this major tax reform can be properly assessed, a few preliminary observations may be made (see also Mann 1990). First, the Bolivian tax reform was obviously a great success in macroeconomic terms: the spiraling fiscal deficit was curbed and the level of current government revenues was more than restored to pre-crisis levels. This happy outcome in part reflects significant alterations in exchange rates and monetary policy (as well as some revival in oil-export revenues), but reestablishing a stable tax system was also a key element in restoring credibility to government policy.

The 1986 reforms succeeded in establishing a revenue structure that was less vulnerable to external fluctuations and inflation than before and easier to administer. Moreover, the new system is probably better in terms of its economic effects and not much (if any) worse in equity terms

21. Again, precedents exist for such actions and such success in Latin America. The most notable case is that of Chile (Harberger 1989), which a decade earlier simplified its tax structure similarly, improved the flow of information to the tax administration, reduced the easily corruptible opportunities for face-to-face negotiations between taxpayers and officials, strengthened penalty structures, and most important, applied the penalties in a generally evenhanded manner (even to the president's brother). Bolivia has not, however, gone nearly as far as Chile in the direction of collecting information systematically. For a discussion of the kinds of information that need to be collected, see Bird (1983).

than the previous system, which was nominally more progressive but poorly administered. These are no small accomplishments, and many other countries would be happy to do as well. What remains unclear is whether other countries could emulate Bolivia's relative success in these respects without first undergoing the severe economic crisis that precipitated the reforms and then made them politically feasible.

Second, it is important to understand the principal ingredients of Bolivian success, particularly because of the universal propensity to search for "easy" solutions to such complex political, social, and economic problems as how to collect taxes in a developing country. Bolivia's success appears to have resulted from four main ingredients. The first two—widespread political acceptance of the need for drastic change and taking tax administration seriously for the first time—have already been stressed.

Two substantive ingredients also made Bolivia's tax reform successful. The first was the strong emphasis on simplification: eliminating minor taxes, investment incentives, and other exemptions from direct and indirect taxes alike; adopting a uniform tariff; and most striking, withdrawing from the complex task of taxing personal and corporate income. Second, the emphasis on effectively administering a uniform, broad-based value-added tax was clearly the key to revenue success. With the exception of Bolivia's abolition of income taxes, such recommendations have been standard in tax studies for decades. The novelty lies in the fact that Bolivia actually carried them out.

Less clear is how significant the more novel parts of the Bolivian reform package (especially the transactions tax and the "complementary tax") were in making the value-added tax a relative success. These devices may have helped to some extent by creating a new *ambiente*, by making taxpayers believe that this time the VAT really was going to be enforced. But any usefulness in this respect probably diminished fairly rapidly. In any case, little reason seems to justify introducing the archaic transactions tax or keeping it.

The future of the complementary tax is more difficult to discern, even if skepticism over its effectiveness in improving the administration of the VAT is accepted. This tax must be considered in the context of the drastic changes in direct taxes that formed a cornerstone of the Bolivian reform. Indeed, except for the extent to which the complementary tax is really a tax on income (or savings), there are now no income taxes in Bolivia. In practice, the yield of the taxes that have replaced the income tax depends on the extent to which the tax administration succeeds in maintaining current market-value assessments of real property.[22] As has often

22. As Cabezas (1990) stresses, these taxes can also be viewed as "presumptive" taxes on income. For example, a 2 percent tax on net worth can be considered the same as an income tax of 20 percent on a presumed income equal to 10 percent of net worth. The fact is, however,

been argued in the context of developing countries, property taxes are good taxes on the whole (Bird 1984b), but they are difficult to administer well, especially in the face of inflation (which crept back up to an annual rate of 20 percent in Bolivia by 1988). It is not at all evident that sufficient resources are being devoted to tax administration in Bolivia to maintain the relatively high standards reached in the late 1980s. Apart from administrative problems, it remains to be seen whether the apparent inequity of not subjecting high-income recipients to any form of direct personal tax will prove to be politically sustainable over time in Bolivia. In contrast, the net-worth tax on enterprises and the simplified system for small businesses seem likely to become permanent and generally desirable features of the tax system in Bolivia.

ARGENTINA: BOLIVIA REVISITED?[23]

Bolivia and Argentina occupy opposite ends of the Latin American spectrum of development, however that rather nebulous concept is measured. Nonetheless, at least some aspects of the Bolivian experience may be emulated in Argentina. The explanation is simple: by 1989 the Argentine economy was almost as bad as that of Bolivia in 1985. Inflation was out of control, the economy was virtually "dollarized," and government economic policy had lost credibility in all spheres. As in Bolivia, the tax system had been heavily eroded by exemptions and incentives, ravaged by inflation, and administered in an increasingly ineffective manner. As one World Bank assessment observed, the Argentine tax administration (the Dirección General Impositiva or DGI) "was one of the most respected public agencies in Argentina 20 years ago. It was known for the high caliber of its technical personnel as well as high morale. The degradation of DGI as an institution has paralleled that of the erosion of the tax system. This degradation has simultaneously been cause and effect of the vicious circle of poor legislation and poor administration that has brought about the collapse of the tax system" (World Bank 1990, 53). Moreover, in keeping with the greater sophistication of Argentina's economy, the formal structure of its tax system was much more complex than that operating in Bolivia before the crisis. All these factors made Argentina at least as

that what is taxed is not income but net worth, which in Bolivia and most developing countries means real estate.

23. This account of the ongoing discussion on tax reform in Argentina may be somewhat outdated because it is based on the limited information available in Dadone (1989), World Bank (1990), and Teijeiro (1990), and on two brief visits to Argentina. I have also drawn on the extensive investigations of the pre-1989 system reported in a series of unpublished studies carried out by Argentine tax experts under the auspices of the World Bank.

ready for a "tax revolution" in 1989 as Bolivia had been in 1985.[24] It is therefore not surprising that the newly elected government of Carlos Menem was soon considering and even adopting portions of a tax reform that in some ways closely resembles the Bolivian package.

The 1988 Reform

The need for drastic change was signaled plainly by the failure of a series of tax reforms introduced by the Alfonsín government at the end of 1988 in an effort to "halt the rot." Although tax revenues in Argentina were relatively high, expenditures were considerably higher. Large budget deficits, chronic inflation, and poor economic growth have been consistent factors in recent Argentine history. Expenditure growth was checked after democracy was restored in the mid-1980s, but the overall fiscal situation did not improve because of continuing deterioration of tax revenues. For example, taxes fell from 22 percent of GDP in 1986 to only 16 percent in 1988.

The original intention of the December 1988 reforms (as in the Bolivian reform) was to make the value-added tax the centerpiece of a revived tax system by broadening its base substantially and improving its administration. The base of the Argentine VAT had been badly eroded since its introduction in 1975 by administrative deficiencies regarding small taxpayers and by legislative giveaways to large taxpayers, especially some extremely ill-conceived and costly regional incentives. The proposed reforms were to be made more palatable by reducing the VAT rate to 14 percent (following a reduction, uncompensated by base-broadening, from 18 percent to 15 percent earlier in 1988). As the reforms were discussed in late 1988, the package was further sweetened by introducing a new 7 percent rate on a range of items as well as additional product exemptions. In the end, as finally passed in December 1988, the upshot was that the so-called VAT reform, contrary to its original objectives, cut rates (and revenues) while complicating administration.

The fate of the other components of the 1988 tax reform was similar. For example, all that was done with respect to the complex direct-tax system was to reduce tax rates. Income tax rates were lowered from the 10–45 percent range to a 6–35 percent range, and the net-wealth tax was cut to 1.5 percent, with a further decrease to 1 percent scheduled for 1990. The only significant additional revenue yielded by the miniscule 1988

24. A "tax revolution" or a drastic reform imposed from above may be contrasted with a "tax revolt," in which taxpayers refuse to comply on such a scale that they force a change in the tax system. In both the Argentine and Bolivian cases, one could argue that the reason a "revolution" was needed is because the "revolt" (noncompliance) had become so successful that the previous system had virtually ceased to function.

"reform," which took the Alfonsín government to the limits of political tolerance, came from that last refuge of desperate governments, increases in excise taxes, particularly on alcohol.

1989 Reform Proposals

In 1989 matters worsened steadily, so much so that when the Menem government unexpectedly came into power early at mid-year, the situation appeared (perhaps perversely) to have become serious enough that even the long-standing preference of Argentines for paying "inflation taxes" rather than regular taxes seemed to have weakened enough to permit real tax reform. For example, one set of proposals considered by the new government in late 1989 strongly resembled those enacted earlier in Bolivia (Dadone 1989). As in Bolivia and fifteen years earlier in Uruguay and Chile (Harberger 1989), one element of the proposed reform was to simplify the system by abolishing a number of taxes that either yielded little revenue or (in the case of the stamp tax) imposed significant inefficiencies on the economy. In addition, a number of payroll taxes earmarked for different funds were to be consolidated into a simpler levy. The most important changes proposed were to introduce a broad-based value-added tax at a uniform rate, a flat-rate income tax at a rate of 20 percent, and a considerably simplified (although still far from uniform) set of taxes on foreign trade. Unlike Bolivia, however, no new taxes were proposed on assets, while the existing taxes on net wealth of individuals and corporations were to be abolished.

The resemblance of these proposals to those adopted in Bolivia is marked in that up to half of the proposed 20 percent income tax, which was to be collected by withholding on all forms of income payments (as in Bolivia), could be paid by producing VAT receipts (like the Bolivian "complementary" tax). Moreover, in a striking example of what might be called the "Chinese menu" approach to tax reform (select one item from one list and one from another list), this system was to be supplemented by adopting the Chilean device of holding a lottery that distributes prizes for tax receipts. But as noted above with respect to Bolivia, the effect of such devices in improving tax administration seems minor. Unless the public perceives a significantly improved administration that will actually utilize such information and enforce taxes and unless this perception is soon reinforced by action, any initial illusory effect seems likely to erode quickly, leaving the administration buried in a sea of unused (and probably often falsified) VAT receipts.

In any case, the tax reform actually proposed to the Argentine Congreso in October 1989 dropped this particular gimmick. It did, however, emphasize broadening the base of the VAT and introduced a 1 percent tax on corporate assets to replace the net-worth tax. As finally approved in late 1989, this new tax was to be applied on gross assets (without allowing for offsetting liabilities) for a period of three years, with the tax paid being creditable against corporate income tax. At the same time, the corporate income tax rate was cut from 33 percent to 20 percent and dividends (now subject to a 10 percent withholding tax at their source) were exempted from personal income tax.

As already emphasized, the cleverest tax design is of little use unless a credible tax administration exists to enforce it. Despite some promising signs, like the adoption early in 1990 of a law imposing criminal penalties on tax evaders, it remains unclear whether Argentines are prepared to face up to the hard and invariably unpopular steps required to restore faith in the tax administration.

Argentina and Bolivia Compared

Without going into further detail on the similarities and differences between the Argentine and Bolivian reforms, the two cases clearly have much in common. Acute economic and political crisis provided an occasion for reversing the prolonged deterioration of tax administration and undesirably complicated tax structures. This combination had produced in both countries an inefficient, inequitable, and unworkable system that neither yielded adequate revenue nor coped adequately with changing macroeconomic circumstances. The new system in place in Bolivia is less vulnerable to erosion by inflation due to its flat rates and extensive reliance on withholding. This system should also be easier to administer because of these features, as well as broader tax bases (few exemptions or "incentives") and increased use of the banking system as a collection agent. Moreover, in comparison with the old system, it may well be more efficient and perhaps even more equitable, despite the absence of rate progressivity or any effective way to reach the traditional "hard-to-tax" groups in any developing country (farmers, professionals, small business owners). How successful Argentina will be in coping with its similar problems in a much more complex economic and political system remains to be seen.

Even a highly simplified tax structure like that now in place in Bolivia requires considerable attention to administration and enforcement if the gains are to be sustained. Whether such a simplified and crude system will prove tenable in the long run in an economically sophisticated and politically divided country like Argentina seems even more questionable. In Argentina in 1990, as in Bolivia in 1985, almost anything seemed better than the status quo ante. The reformed system introduced in 1990 almost certainly constituted an improvement. It seems unlikely, however, that the new tax structure will remain unchanged for long, given the demonstrated Argentine propensity for fiddling with the fiscal system in attempts to cure regional and sectoral ills. The direction of change may be for the better (if strengthened administration permits more effective personal taxation) or for the worse (if the traditional propensity to use the tax system for all sorts of nonfiscal purposes reasserts itself). In any case, it seems unlikely that the more sophisticated Argentine economy will remain content for long with a system that might suit the much simpler circumstances of Bolivia for a longer period.[25]

ADJUSTING TO REALITY: TAX REFORM IN MEXICO AND COLOMBIA

Tax reforms in Mexico and Colombia in recent years have been by no means as dramatic as those in Bolivia or Argentina. Yet their cumulative impact has been significant. In contrast to the two cases already discussed, the Mexican and Colombian reforms represent not a sharp break with the past stimulated by extreme external pressure but rather a process of gradual adaptation to changing circumstances.

When the choice is as stark as "adapt or cease to exist," the fundamental societal instinct for survival might force almost any country to adopt reforms necessary to avoid extinction. The next country to face such a choice may be Peru, where (as in Argentina) sociopolitical stresses have thus far made it impossible to cope with the need for substantial economic reform (Ascher 1989). Peru, however, may discover a brief window of opportunity for the new government elected in 1990, provided that the economy continues to worsen and the polity holds together long enough to permit some drastic action. Both parts of this proviso are important: things may have to get worse before Peruvians change their attitudes sufficiently to permit matters to improve. But if things get too bad, no feasible change may provide a solution, as has been demonstrated in Lebanon.

Fortunately, matters do not reach such desperate straits in most countries most of the time. A given situation may often be bad, but it is seldom so hopeless that sociopolitical groups are prepared to give up their most treasured beliefs and shibboleths in an effort to save themselves and their country from irretrievable disaster. Countries as diverse as Guatemala and Venezuela are in economic trouble in one way or another and are considering or enacting tax reforms as one means of "self-help."[26] But

25. In contrast, Paraguay, although by no means as crisis-ridden as either pre-reform Bolivia or present-day Argentina, would appear to provide a more suitable environment for the essential elements of a Bolivian-type reform: a low and uniform tariff, a broad-based flat-rate VAT, and heavy reliance on withholding and presumptive techniques to collect direct taxes. (This comment is based on a brief visit to Paraguay in 1989.)

26. For another interesting recent experience, see the Jamaican case discussed in Bahl (1989). Trinidad also introduced a major tax reform in 1989 with considerable economic success, although resentment of the new VAT has been cited as a minor reason for the short-lived

https://doi.org/10.1017/S0023879100016599 Published online by Cambridge University Press

because these countries are not teetering on the brink of disaster (unlike Bolivia in 1985 or Argentina in 1989), they may be less willing to contemplate such quick and drastic reforms. Mexico and Colombia offer intriguing examples of what can be done in such circumstances, as well as a notable contrast in several respects. This section will briefly highlight only a few of the interesting characteristics of tax reform in these two countries.

Mexico: A Decade of Reform[27]

Mexico's first reform effort in the early 1970s basically followed the lines common in the 1960s, moving the existing income tax a bit toward a more comprehensive tax base by increasing the withholding tax on interest income and attempting to tax rental income from housing more effectively (Bird and Oldman 1968). Around the same time, the federal turnover tax (similar to the Bolivian transactions tax already discussed) was modified in a way that made it easier to replace subsequently by a value-added tax.[28] The incremental nature of these reforms, which built on rather than completely rejecting the existing system, has proved to be an enduring characteristic of subsequent Mexican reforms.

When circumstances in Mexico became ripe for reform again in the late 1970s, more significant changes were made in income and consumption taxes. Initially, a general value-added tax was introduced in 1980 across a broad base at a rate of 10 percent (except for a 6 percent rate applied in the strip along the U.S. border to approximate the retail sales taxes in the U.S. border states). As in other countries, Mexico used the occasion of introducing the VAT to eliminate a large number of small, relatively unproductive consumption taxes, thus simplifying the tax system substantially. Unfortunately, the initial simplicity of this reform was soon eroded by the extension of exemptions and, when external circumstances required more revenue in 1983, by raising the basic VAT rate to 15 percent and introducing several additional rates. To meet the revenue crisis, excise taxes were also increased notably (they had been shifted to

uprising in 1990. Major explicit tax changes are almost invariably political dynamite, which is one reason why they usually occur only when no other option is open. In Latin American terms, this point has too often meant only when the International Monetary Fund really puts on the pressure. The role of international agencies in this politically delicate area cannot be explored further here, however, because little is known of it and what is known cannot be documented.

27. This section is based largely on an unpublished study made for the World Bank by Francisco Gil Díaz as well as on Gil Díaz (1987) and my own earlier work in Mexico, as reflected in Oldman and Bird (1977).

28. The modification concerned the revenue-sharing system with the states. In every case discussed here (Bolivia, Argentina, Mexico, and Colombia), a significant factor that had to be taken into account in reforming national taxes was the dependence of subnational governments on the same (or related) tax bases.

an ad valorem basis when the VAT was introduced). A 10 percent surtax was also added to the income tax.

The course of reforming the Mexican income tax in recent years has by no means gone smoothly. To begin with, the tax base was broadened by including some capital gains and dividends. Then inflation adjustments were introduced in corporate and personal taxes to reduce the distortions caused by inflationary changes in tax bases and to protect revenue from the ravages of inflation by shortening collection lags substantially. A key feature of the inflation adjustment package was introducing a system of instantaneous depreciation of the present value of fixed assets (discounted at a real interest rate of 7.5 percent).[29] In addition, the corporate tax rate was lowered from 42 percent to 35 percent. After a brief leap to 60.5 percent in 1983 (by way of political "compensation" for the increase in the VAT rate that year), the top marginal rate of the personal income tax was also lowered, reaching 40 percent in 1989.

The government of Carlos Salinas de Gortari, which took office in 1989, was faced with the unpleasant necessity of raising revenues once again. It did so in part by introducing a 2 percent tax on the inflation-adjusted assets of firms (excluding shares in other firms), somewhat along the lines of the similar Bolivian and Argentine taxes. As in Argentina (which seems to have emulated Mexico in this regard), this tax is creditable against the income tax and thus functions as a minimum corporate tax. In addition, both Mexico and Argentina levied a flat 10 percent tax on dividends paid to individuals.[30]

Throughout this extended period of tax reform, the Mexican authorities appear to have been motivated by several factors that were not always consistent. In the first place, the need to increase the real yield of the tax system has been obvious, as evidenced by the increases in the VAT rate, the changes in excise taxes, the attention paid to shortening collection lags, and the introduction of a corporate minimum tax. Second, substantial concern has been evident with respect to the efficiency aspects of taxation and particularly the constraints on tax policy imposed by the openness of the Mexican economy, as evidenced by the special VAT

29. Although such a system of partially "expensing" capital goods had been proposed earlier by Nicholas Kaldor for Sri Lanka (Kaldor 1960) and discussed by Harberger for Bolivia (Musgrave 1981), it received new attention when proposed by Auerbach and Jorgenson (1980). Quick adoption of this "new" idea by Mexico perhaps suggests that although Mexico has tended to rely much less on visiting foreign experts than, say, Colombia, Mexican technocrats are as susceptible to prestigious foreign influence as those in other countries.

30. The similarity between the Mexican reform in 1989 and the slightly later Argentine reform the same year is not entirely coincidental. The tax fraternity, like most technocratic groups, keeps in fairly close touch through meetings like the annual conference of the CIAT (Centro Interamericano de Administradores Tributarios) and via the peregrinations of *técnicos* from such agencies as the World Bank and the IMF. The latter's Fiscal Affairs Department has been a particularly active cross-pollinator of fiscal ideas in Latin America.

rate for border areas, inflation adjustments, and the reduction in corporate tax rates. Third, while more concern with equity (real or perceived) has been apparent in Mexico than in Bolivia or Argentina, as shown by the example of the temporary increase in income tax rates in 1983, administrative feasibility seems to have played a lesser role in Mexico than in either of the other two countries.

Finally, in virtually every instance tax reform in Mexico was presented as a logical outgrowth of previous experience, as an incremental (if episodic) change rather than a holistic one. Taken as a whole, the Mexican tax reform of the last decade has been substantial. But in fact, it never was taken as a whole but rather in small, more digestible pieces. Mexico's tax reform is thus best seen not as a "response to crisis" but as an ongoing process of adjustment to changing circumstances and, to some extent, to changing intellectual fashions.

Colombia's Periodic Tax Reform[31]

Tax reform in Colombia has exceeded Mexico's in the duration of the process and also in the extent to which it represents not "crisis reform" but a process of periodic shifts and adjustments to changing circumstances (external crises or bouts of inflation) and changing fashions in taxation. Recent experience with tax reform in Colombia started in a sense with two important foreign missions in the 1960s (Taylor 1965; Musgrave and Gillis 1971). But even earlier, significant reforms had been undertaken in the 1950s and 1960s, especially following a study by the United Nations Economic Commission for Latin America (ECLA or CEPAL).[32] These reports, particularly the Musgrave report, were important not for their immediate effect on tax reform—indeed, little effect was evident. Their indirect effect was considerable, however. The reports involved a group of young Colombian technicians in intensive discussions of taxation issues and also set forth a broad agenda for future tax reform.

In particular, the important tax reform of 1974 clearly reflected both the intellectual and personal impact of these missions. This reform was evidently the product not of foreign ideas as such but of the pragmatic application of these ideas by Colombians, combined with their own, at the political and technical levels. Similarly, the later 1986 reform was largely the product of Colombians thinking about their own problems. Most recently, another foreign report was clearly influential in the most recent

31. Over the years, Colombian tax reforms have been studied at length by many authors. The present account is based largely on an unpublished study prepared by Charles McLure and George Zodrow for the World Bank, as well as on McLure and Pardo (1989), McLure (1989), and Perry and Cárdenas (1986). I have also drawn on my own earlier work (Bird 1970, 1984b), Musgrave and Gillis (1971), Gillis and McLure (1977), and McLure et al. (1989).

32. This earlier experience is discussed in Bird (1970).

reform in 1988 (McLure et al. 1989), but the major changes made reflected the close involvement of the chief policymakers in the work of the foreign mission and their judicious balancing of theoretical desirability and practical feasibility.

On the whole, Colombian experience with foreign tax advisors over the years has demonstrated that effective use can be made of foreign expertise with two provisos: first, that a competent group of local experts exists, and second, that the responsible policymakers help determine the reform recommendations. Without these conditions, the only result of a foreign tax mission is likely to be another volume gathering dust on library shelves.

The substantive nature of the several tax reforms in Colombia varied considerably. The first major reform in 1974, like the contemporaneous reforms in Mexico, concentrated on the income tax and tried to move it closer to the traditional "comprehensive" ideal, unlike the reforms of the same period launched in Chile and Uruguay (Harberger 1989). Aided by the long-standing net-wealth tax and the introduction of a "presumptive" minimum income tax based on net wealth, this reform produced significant revenue for a time and probably increased the progressivity of the tax system substantially (Perry and Cárdenas 1986). Failure to implement some essential administrative reforms, however, combined with inflation and the unrelenting political pressure of adversely affected groups to erode this early success. Many further reforms were made over the next decade, lightening and then tightening income taxes, especially introducing and expanding a value-added tax. By 1986, however, it was time for another major reform.

The 1986 Colombian reforms were unique in Latin America in that they were not precipitated by a revenue crisis and were intentionally "revenue neutral" (intended primarily to reduce the economic distortions created by raising a given amount of revenue). Although some partial inflation adjustments had been made since 1974, the 1986 reform went considerably further in this direction, moving taxation (and deduction) of interest to a real rather than nominal basis. The 1988 reforms went further still, beginning a gradual move to a fully indexed tax base, similar to that adopted for business and capital income in the much more inflationary economy of Chile a decade earlier (Casanegra de Jantscher 1985). A number of other changes were introduced in 1986 to simplify the direct tax system. For example, by abolishing personal exemptions, income splitting, and most itemized deductions, the reform eliminated the need for most taxpayers to file returns. The distorting effect of the tax system on economic decisions was further reduced by such measures as unifying the treatment of corporations and countries with limited liability, lowering the top rate of the personal income tax to 30 percent (equal to the new unified business tax), and exempting dividends from taxation at the individual level. Like the abolition of the net-wealth tax announced in 1989, some of these changes seem more dubious in theoretical (if not necessarily real equity) terms than in terms of efficiency. For the most part, however, all these measures score fairly well in improving the administrability of the system.

Perhaps the most outstanding feature of Colombia's tax reform experience has been the marked contrast between the earlier reforms in 1974 and the later ones in 1986. The earlier reform ambitiously sought to achieve at least some of the textbook virtues of comprehensive income taxation. But it ignored the realities of inflation and administrative limitations (owing in part to judicial invalidation of the relevant legislation). The later reform, while clearly influenced by the "new" textbook model of an efficient tax system as one with lower rates and broader bases, faced the reality that inflation is likely to persist for a long time and was much more modest in undertaking to achieve equity through tax policy, partly in recognition of the constraints imposed on policy by administrative feasibility.

The Colombian tax system, like that in Mexico, may still be "roughly just."[33] In both cases, however, recognition of the inevitable "roughness" (approximate nature) of the distributional objectives that can be attained in an open economy with severely limited administrative capability has led to a much more restrained approach to redistribution through the fiscal system than was common in earlier years. Similarly, Colombia, although never as far down the path of fiscal incentives as Argentina (where tax incentives gave away at least 10 percent of tax revenue in 1988, according to World Bank 1990), has clearly retreated a long way from the days of the CEPAL-inspired view of tax incentives as an essential tool of interventionist development policy (Bird 1970). The same is true of the other countries discussed here.

Unfortunately, while administrative realism has obviously influenced formulation of recent tax policy in Colombia, it is not clear that sufficient attention has been paid so far to the essential task of improving tax administration itself rather than redesigning the system around its imperfections. For example, much has been done to improve tax administration in Colombia by introducing bank collection, eliminating burdensome and ineffective procedures, and so on (McLure and Pardo 1989). Yet Colombia has certainly not been able to overcome the fundamental problem bedeviling direct tax administration in most of Latin America: the

33. No attempt will be made here to analyze the distributive effects of the various tax reforms described because the data needed are lacking and because substantial doubt exists as to whether the usual measures of fiscal incidence mean much anyway. For an earlier review, see Bird and DeWulf (1973). Perry and Cárdenas (1986) say what can be said about this issue in Colombia up to the early 1980s.

political impossibility of enforcing taxes on rich and powerful taxpayers (Urrutia 1989). Perhaps something like a Bolivian-style crisis is required before governments can face the unpleasant reality that if they are to establish a really stable tax base, at some point they must search out and penalize tax evaders, even their friends.

Finally, perhaps the significant feature of tax reform in Colombia is how often such reforms have been undertaken. One observer has claimed that carrying out a tax reform seems to have become almost an expected assertion of authority by Colombian governments (Ascher 1989). The near total absence of significant reform in neighboring Venezuela illustrates the strength of a contradictory adage in the tax-reform field: as a rule, countries only reform taxes when they have to do so.[34] As long as the oil money kept rolling in, Venezuela did not need to reform its tax system and therefore did not. The thorough report of the important mission led by Carl Shoup (Shoup et al. 1959) brought about some structural change in the Venezuelan income tax in the mid-1960s (Gittes 1968). But neither these changes nor the non-oil income tax loom very large in the Venezuelan tax picture, which has long been dominated by oil revenues. When it became apparent that the oil bonanza was coming to an end in the 1980s, a major tax reform commission was established to lay the foundations for a much-needed restructuring of non-oil taxation (CERF 1983). Nothing much in the way of reform has yet been accomplished, however.[35]

LESSONS FOR REFORMERS

As noted at the outset, it would be presumptuous to attempt to draw a coherent set of lessons for would-be tax reformers in Latin America from the few and diverse country experiences summarized here.[36] Nonetheless, two kinds of lessons seem to emerge fairly clearly from these experiences and from more general experience with tax reform in developing countries over the last thirty years. The first type of lesson relates to the substance of tax reform and the second to the process of tax reform. At first glance, lessons about substance—what was done—may seem more applicable, while process—how it was done—may appear to be more abstract and less useful to would-be reformers in the short term.

34. This brief section has gained considerably from reading McLure (1991, 1990) and from several visits to Venezuela in earlier years.

35. This commission drew heavily on work by IMF experts, as reported in Aguirre et al. (1986) and Griffith, Escobar, and Pavesi (1986). A striking contrast can be observed between Venezuela and Indonesia, where a major tax study was launched around the same time and for the same reason but was actually carried out (Gillis 1985). Perhaps, however, this contrast only reinforces the earlier point that democracies find it difficult to reform taxes unless they are forced to the wall. Like Chile in its salad days of tax reform, Indonesia is hardly a democracy.

36. For a well-taken warning from a political scientist on the propensity of would-be tax reformers (including me) to generalize too hastily from limited experiences, see Bates (1989).

In fact, however, the reverse seems likely to be true: clear understanding of the process by which reform is accomplished seems critical to success, while the substance of reform, which often seems to reflect what may prove to be passing intellectual fashions, may hold only transitory interest.

Four general points regarding the substance of tax reform emerge from the foregoing discussion and general discussions on tax reform in Latin America and elsewhere in recent decades.[37] First, the nature and the objectives of tax reform have changed substantially in recent years. Second, the value-added tax now plays a central role in most large-scale tax reforms. Third, much greater awareness now exists of the significant constraints imposed by the administrative dimension of tax reform. Fourth, some reformers in Latin America nevertheless remain tempted by tax gimmicks that promise reform without requiring the slow and painful process of creating an adequate system of public administration. Each of these points deserves brief elaboration.

Income Taxes

The move to lower marginal rates of income taxation, particularly in the top brackets, has been widespread: in recent years, Colombia lowered its top rate from 49 percent to 30 percent, Bolivia from 40 percent to 10 percent, Argentina from 45 percent to 35 percent, Guatemala from 42 percent to 34 percent, and El Salvador from 60 to 35 percent (Jenkins 1989). Bolivia has actually gone further than these figures suggest in effectively abolishing income tax for most citizens, while Colombia has moved to a gross income basis for most taxpayers.[38] In some countries, such as Mexico and Colombia, the base of the income tax has also been broadened to some extent by such measures as including some capital gains.[39] This marked change in the orientation of income taxation appears to have occurred for a number of related reasons.

One evident trend has been a turn away from using the tax system to redistribute income. The day when one could consider the tax system to be "the supreme equalizer" of the economic system (OAS 1973), the main means of correcting inequalities in income and wealth, has passed.[40] This

37. For particularly useful recent discussions of this subject, see Bahl (1989), Gillis (1989), and Jenkins (1989).

38. Beyond Latin America, that most Latin of Asian countries, the Philippines, has gone considerably further in the direction of gross (rather than net) income taxation, with no allowance for personal circumstances, as shown in Asher and Kintanar (1989).

39. The importance of such inclusion is not that many capital gains will be subject to tax—they will not. The point is that other forms of income like salaries cannot then be converted into capital gains and thus escape taxation more or less legally.

40. This turn away from progressive income taxes is by no means confined to Latin America. For an overview of recent income tax reforms in the countries of the Organisation for Economic Cooperation and Development, see Cnossen and Bird (1990); and for an assessment of the changing role of the income tax in historical perspective, see Bird (1988).

trend reflects a reversal in attitude since the earlier wave of tax reform (the Taylor 1965 and Musgrave and Gillis 1971 reports in Colombia actually recommended increases in the top income tax rate). One reason behind this shift is heightened perception of the severe constraint that administrative factors impose on redistributive taxation.[41] As I have argued elsewhere at length (Bird 1989b), policymakers need to understand that it is not simply lack of political will that hinders imposing highly progressive taxes in developing countries. There are also real administrative limits on what governments in such countries can do.

Manifest disillusionment with the ability of the tax system to redistribute income seems almost matched by a parallel disillusionment with the ability of tax measures to redirect and reallocate resources, to "fine-tune" the economy. Tax incentives are going out of style almost everywhere, perhaps even in Argentina. Their pernicious effects on revenues—which by creating effectively tax-free "onshore havens," extend far beyond their direct revenue costs—combined with their demonstrated ineffectiveness in producing sounder patterns of growth have made the elimination of incentives a favored way of expanding tax bases and financing rate reductions in developed and developing countries alike. Equally important, heavy reliance on tax incentives is no longer in tune with the dominant policy trend. For better or for worse, the interventionist policies of the 1960s have increasingly been replaced by the more "market-oriented" policies of the 1980s.[42]

Value-Added Taxes

The centrality of the value-added tax in tax reform in Latin America is now unmistakable. As in the rest of the world (Tait 1988), this form of general consumption tax has come to play a critical role in all attempts to "modernize" the tax system. In particular, reforms engendered by fiscal crisis, which invariably call for increases in revenues, can often attain their revenue goals only by relying on the value-added tax.[43] Moreover, it is evident that effective value-added taxation requires a fairly competent tax administration. Contrary to prevailing myths, the VAT is in no sense a "self-enforcing" tax (Casanegra de Jantscher 1990). The truth of this prop-

41. An additional important constraint on redistributive taxation is imposed by the increasing openness of many Latin American economies (see Bird and McLure 1990), but this aspect cannot be developed further in the present context.

42. Contrast, for example, Kaldor (1965) with Lindbeck (1987). The latter is reprinted in part in Bird and Oldman (1990).

43. This point is stressed especially in Gillis (1989).

osition has been demonstrated by VAT deterioration in Bolivia and Argentina in the early 1980s.[44]

Constraints on Reform

In recent years, would-be tax reformers have become increasingly aware of the constraints on tax reform imposed not only by the vocal political opposition that reform almost invariably engenders but also by the genuine limits of administrative feasibility (Bird 1989b). The Bolivian and Argentine episodes bear witness to the truth of this claim, but its importance is also evident in many other countries. The limits imposed by international capital markets on income taxation in developed countries (Bird and McLure 1990), let alone in developing countries like those in Latin America, provide yet another reason for expecting the turn away from income taxes already evident throughout the region to be more than a passing fancy, at least in the absence of a much greater degree of international cooperation in taxation than seems likely to emerge in the near future.

The Weakness for Gimmicks

Many positive observations can be made about the Bolivian tax reform. Unfortunately, however, it appears that in this case (as in the prior experience of Chile) some observers have confused the frosting with the cake, considering the essence of the Bolivian (or Chilean) reforms to be the introduction of such "clever" structural devices as crediting VAT receipts against income taxes or holding lotteries based on VAT receipts.[45] The real "secret" of success lies not in such gimmicks but in the more mundane task of establishing a more credible and effective tax administration.[46] Such devices might help alter public perceptions of the probability of being caught, but unless tax administration is in fact made more credible and effective, such an impression is likely to fade quickly. If tax administration is improved (as in Bolivia) by such proven techniques as extensive reliance on withholding, replacement of complex taxes with simple ones, improved use of available information, and visible enforcement activity, then gimmicks intended primarily to increase the flow of information to the administration may provide some extra benefit. In no

44. See also the account of the initially poor results of the value-added tax introduced in Guatemala in 1983 in Bird (1985).

45. Another superficially attractive but fundamentally unsatisfactory tax "gimmick" found all too frequently in Latin America is the tax amnesty (Bird 1989b).

46. As Harberger has described the matter, the lessons of tax reform are "not exciting—more like 'how to be a good public accountant' than 'how to be a star in the movies or in the opera or on the football field'" (1989, 27).

circumstances, however, can such gimmicks take the place of improved administrative effort.

The Process of Tax Reform

The process lessons of tax reform may be subdivided into two groups: those related to how reform may be brought about and those related to when reform may be possible. Perhaps the most obvious lesson concerns the timing of reform. With some exceptions (such as Colombia in 1986), major changes in tax structure and administration are usually possible only when times are bad, during a crisis of some sort. Only then is it possible to overcome the coalition of political opposition and administrative inertia that normally blocks significant change in "quasi-constitutional" matters like distribution of the cost of government.[47] Unfortunately, at the very time when tax reform may be most politically feasible, it is also likely to prove most difficult to do well, unless the government is already prepared to act.

Being prepared to carry out major tax reforms in times of crisis requires careful planning and preparation. As the Bolivian case illustrates, such planning need not occupy a long period of time but must be based on a lucid conception of the objectives of reform. Moreover, even the best-laid plans of technicians will come to naught unless key political and administrative figures are involved in the planning from the beginning. Only then will both groups be committed to the reforms they have helped formulate and ready to act when the time comes. These two conditions for success were more or less satisfied in all three of the major cases considered here—Bolivia, Colombia, and Mexico—as well as in Chile earlier. They have not been met thus far in countries like Venezuela, Argentina, and Peru.

In short, the unsurprising conclusion is that countries in crisis where politicians are committed to reforms with clear-cut goals are the ones most likely to be able to introduce major tax reforms. These same factors also go a long way toward ensuring that such reforms can be implemented successfully. Other ingredients required for success in this respect are a sufficiently competent and prepared "technical" group to design sensible reforms and, above all, enough attention to the critical task of enforcement in designing reforms that can be administered and ensuring that the tax administration is strengthened enough to be able to

47. Gillis (1989) places less emphasis on the political coalition problem, possibly because of his experience with the relatively strong government in Indonesia (Gillis 1985). In contrast, Gillis (1989) is quite right to stress the importance of the relative continuity of the governing (and technical) elite in the Indonesian case as being critical to success. See Urrutia, Ichimura, and Yukawa (1989) for a comparison of Latin American and Asian experience that emphasizes the same point.

implement the reformed system. Without these conditions, the best advice in the world will be useless. With them, as demonstrated to varying extents in all the cases here (but most clearly in Colombia), such advice can sometimes be useful.

CONCLUSION

The kind of tax reform that seems likely to be adopted these days in even the most sophisticated Latin American countries appears to differ considerably from the nominally progressive income tax that has existed (on paper) in most countries and long been urged by would-be reformers.[48] Because an effective general sales tax has increasingly become the cornerstone of a successful revenue system in developing countries, the first concern of serious tax reformers these days is almost invariably to implement such a tax, probably a VAT in most countries in Latin America.[49]

Accompanying the rise of the VAT throughout the region has been a move away from progressive income taxation. In part, this shift may reflect lessened emphasis on redistribution through the fiscal system as a policy objective. In addition, the de-emphasis on direct and progressive personal taxes appears to reflect the realization that such taxes have not been and probably cannot be effectively administered in most Latin American countries. The necessity of this marked shift in tax-policy emphasis certainly calls for further study, as does its desirability. What cannot be questioned is that, for better or worse, the highly progressive "global" income tax that once ranked as a key instrument in every tax reformer's tool kit no longer seems to be considered feasible, not even in the most sophisticated countries of the region.

48. For an interesting early Brazilian exception to the then prevalent enthusiasm for global progressive income taxes, however, see Rezende (1976).

49. A possible exception is Paraguay (and perhaps a few other smaller economies like those in Central America), where a simpler form of sales tax than a full-fledged VAT would seem an advisable interim step. For a related analysis of a simple economy in another part of the world, see Bird (1989a).

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