

# WORLD BANK TAX ADVICE FOR LATIN AMERICA: HOW TO OBSTRUCT SUSTAINED AND EQUITABLE DEVELOPMENT

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## *Abstract*

*Taxation is critical for satisfying basic needs and generating an inclusive development process that benefits the poor as well as the rich in Latin America. The World Bank offers tax advice to developing countries, and it pressures countries to follow that advice by making it a condition for receiving development loans at preferential interest rates. This paper argues that in response to a short-term financial crisis, the World Bank recommended a regressive tax system that raises revenue quickly, but, in the long-run slows the satisfaction of basic needs and obstructs the implementation of an inclusive development process. The article concludes with recommendations for an alternative tax policy.*

## **Introduction**

Approximately one in four people in Latin America live on less than \$2 per day. At the same time, Latin America is the most unequal region of the world (McGuire 2005, pp. 7, 15-16). This poverty and inequality lead to domination, exploitation and exclusion of the poor from the development process.

The best solution to this disaster includes a development process that benefits the population as a whole, not just a privileged few. Instituting an inclusive development process requires satisfying the basic needs such as health and education that enhance the productivity of the poor. Enhanced productivity generates new opportunities to participate in the production process and to earn the income necessary to live a full and dignified life. The nature, implementation, advantages and feasibility of a Basic Needs Approach to Development are treated more fully in the literature (Hicks, 1979; McGuire, 2005; Stewart, 1985; Streeten, Burki, Haq, Hicks, Stewart, 1981).

Taxation is critical for satisfying basic needs and generating an inclusive development process. First, taxation raises the revenue necessary to pay for basic goods and services. Second, progressive taxation (meaning that the rich pay a relatively high percentage of their incomes in taxes) speeds the satisfaction of basic needs. Regressive taxation that falls heavily on low-income persons slows the satisfaction of those needs. Taxing an extremely poor family in order to build a new school, for example, tends to leave the children of that family more hungry and less able to learn.

The World Bank (WB) makes development loans to low-income countries at preferential interest rates. In order to qualify for those loans, the countries must meet a range of conditions. Beginning in the 1980s, the WB began developing advice on taxation and making that advice an ever more heavily stressed condition that must be

satisfied in order to receive a loan (World Bank, 1991, pp. 7-10). Between 1980 and 1989, the WB made 94 adjustment loans totaling \$12.63 billion with tax policy components. More than 90% of these loans contained tax policy conditions (World Bank 1991, p. 73).

Restricting loans to only those developing countries that agree to adopt the WB tax advice brings heavy pressure on those countries to conform. Not surprisingly, empirical studies indicate that virtually all Latin American countries have generally followed the WB's tax advice (Thirsk, 1997, pp. 18-24; Pita, 1993, pp. i-iv).

The purpose of this article is to explain the origins of the WB tax advice, to describe its essential elements, and to evaluate its effect on generating an inclusive development process through satisfying the basic needs of the low-income people of Latin America.

The analysis finds that in response to a short-term financial crisis, the WB recommended a regressive tax system that raises revenue quickly, but, in the long-run, obstructs the satisfaction of basic needs and delays the implementation of an inclusive development process. The article concludes with recommendations for an alternative tax policy.

The web site of the WB states that its tax advice is described and explained primarily in *Lessons in Tax Reform* (World Bank, 1991) and in Chapter 1 of *Tax Reform in Developing Countries* (Thirsk, 1997; World Bank, 2006a). The description of WB tax policy is based mainly upon these sources.

## **How To Design A Tax System**

Designing a tax system is a two-step process that is both an art and a science. The first step is to determine the primary objective of the system. The second is to select the taxes that meet that objective.

### **First Step: The Objective**

Designing a tax system begins with selecting a primary objective. Normally, the primary objective of the tax system is dictated by the real world circumstances of the country. Science helps to describe and explain the circumstances, but selecting the primary objective is largely an art. Once the circumstances are known, priorities must be set. Should the primary objective be to satisfy basic needs or to control inflation? In order to decide, the tax "artist" must consider not only the economic circumstances but also values, politics, special interests, culture and history.

Secondary objectives for the tax system may also be selected. An often-used source of both primary and secondary objectives is a handy list of "requirements for a 'good' tax structure" developed by Richard and Peggy Musgrave in their classic work on public finance (Musgrave & Musgrave, 1989, p. 216). In short, a "good" tax system: (1) raises sufficient revenue; (2) distributes the tax burden fairly; (3) minimizes interference with economic decisions; (4) facilitates the use of fiscal policy to achieve full employment

without inflation: (5) permits fair administration: (6) is understandable to the taxpayer: and (7) minimizes administration and compliance costs. Economists try to satisfy all of these requirements at least insofar as they serve the primary objective.

## **Second Step: The Taxes**

The second step of designing a tax system is to select a set of taxes that achieves the objectives. The science of economics drives this step. For example, economic theory helps to determine who ultimately bears the burden of a tax after changes in behavior are taken into account. Does the buyer or the seller bear the burden of a sales tax?

The process of designing a tax system shows that there is no one system that is indisputably the best set of taxes for any one country. One may legitimately dispute not only the objectives but also the particular taxes adopted to achieve them. “There is no unique prescription for the design of a single tax or a system of taxes, nor is there a single country in which all taxes are optimally designed” (World Bank, 1991, pp. 57-58).

This paper argues that, due to the Latin American debt crisis of the 1980s, the WB adopted as its primary objective raising the maximum amount of tax revenue in the easiest possible way in the shortest possible time. It then designed a tax system to meet this objective. This path forced the WB to reinterpret and subordinate the other “requirements of a good tax system” in order to fit them into its plan to increase tax revenue fast.

The long-term result is that Latin America is saddled with a more regressive tax system that obstructs the satisfaction of basic needs and the institution of an inclusive development process. This implies a catastrophic prolongation of the poverty and inequality that plague Latin America.

## **Primary Objective And Tax Advice**

### **The Economic Context: The International Debt Crisis**

Beginning around 1950, Latin America adopted the Import Substitution Industrialization (ISI) approach to development. One influential rationale for ISI was provided by Dependency Theory. This theory argued that Latin America was underdeveloped because it was *dependent* upon the industrialized world, especially the United States. The solution was to become *independent*. How? By industrializing and producing at home the goods and services that were being imported. Hence the name: Import-Substitution-Industrialization.

In order to industrialize, Latin American governments began spending huge sums of money. Expenditures were made for investments in public enterprises, for infrastructure, for subsidizing private enterprises and for many other items thought to foster industrialization.

The enormous spending generated huge fiscal deficits in which government expenditures exceeded revenues. In a sample of thirty-three developing countries, public

sector deficits averaged 7 percent of Gross Domestic Product (GDP) in 1986 (Chhibber & Khalilzadeh-Shirazi, 1988, cited in World Bank, 1991, p. 17). By comparison, the fiscal deficit of the United States in 2005 was approximately 2.6 percent of its GDP (Congressional Budget Office, 2006).

Latin American governments, like everyone else, have to pay their bills. How can they pay, if expenditures are greater than revenues? One answer was to borrow money from commercial banks in the United States and other industrialized countries.

After an initial spurt of industrialization, ISI faltered. Production and income failed to grow in Latin America throughout the “lost decade” of the 1980s (Franco, 2003, Table 3.3, p. 65). Latin America stopped earning the income on its investments that it needed to pay its debt. In 1982, Mexico defaulted on its international debt, and other countries were in danger of following suit.

Suddenly, the U.S. banks that had loaned many billions of dollars to Latin America and the international banking system in general—were in danger of collapse. In 1982, the exposure of nine top U.S.-based banks to shaky foreign loans was twice the entire value of their own paid-in capital (Lindert & Pugel, 200, p. 570). Lending by the commercial banks to Latin American governments skidded to a halt.

Since the Latin American governments could not borrow the money that they needed in order to pay their bills, they were driven to “print money.” But excessive increases in the money supply generated inflation. The average annual inflation rate in Bolivia between 1980 and 1985 was no less than 2,252% (Cardoso, 1992, p. 141). In 1990, Peru experienced an inflation rate of 7,482 percent, and in the same year, the inflation rate of Brazil was 2,937 percent (Franco, 2003, p. 114).

Inflation, in turn, caused Latin American exports to become relatively expensive. The resulting decline in exports meant that Latin America was not earning the foreign exchange it needed to repay its debt to the banks of industrialized countries.

Inflation also hindered growth in Latin America. Rapidly increasing prices cause uncertainty which slows production and investment. Stanley Fischer compiled data for 80 developing countries, covering the early 1960s to the middle 1980s. His regressions demonstrate that higher inflation is closely correlated with reduced economic growth (Fischer, 1993, cited in Gillis, Perkins, Roemer, Snodgrass, 1996, p. 114). The lack of growth meant not only unemployment in Latin America, but also, a failure to produce the exports that earn the foreign exchange needed to repay the banks.

The situation was critical and something had to be done immediately. WB economists concluded that the key to resolving the crisis was to eliminate the fiscal deficits that were forcing governments to print money and generate inflation. One way to eliminate the fiscal deficits was to increase tax revenues.

## Primary Objective: Revenue

Thus arose the WB's primary objective for taxation—raise the revenue necessary to eliminate fiscal deficits, and raise it as quickly and easily as possible. The WB writes:

How to contain and rationalize an over-expanded public sector has become one of the principal challenges facing many developing countries in recent years. In this context, the rationale for tax reform is twofold: first, as part of structural adjustment, tax reform is designed to reduce severe distortions in economic incentives and the resulting inefficiencies and inequities in the allocation of resources; and second, as part of efforts to stabilize the economy, tax reform, in tandem with cuts in public expenditure, may be needed to **generate public revenue** in a reasonably non-distorting, equitable, and sustainable manner” (World Bank, 1991, p. 2).

Here, the WB states that its first objective is to “reduce . . . inefficiencies and inequities,” and that its second objective is to generate public revenue. However, the argument of this paper is that the primary objective was to generate revenue in order to reduce fiscal deficits, and that efficiency and equity were reinterpreted and pursued only insofar as they contributed to raising tax revenue.

## World Bank Tax Advice for Revenue

The WB offered a variety of tax recommendations for raising revenue, but the principle advice was to implement a new sales tax and to lower the maximum marginal income tax rates. Other recommendations included reducing exemptions from both taxes, instituting a system of withholding for the income tax, and improving tax administration.

## The Value Added Tax

The principal advice for raising revenue was to institute a sales tax called the Value-Added Tax (VAT). “Revenue would be generated primarily by a broadly based domestic tax on consumption . . . . The best instrument to achieve this objective would be a VAT . . . .” (World Bank, 1991, Box 11, p. 57).

The VAT is equivalent to a general sales tax like we have in the United States. It is a good generator of revenue because it is relatively easy to administer and because it contains self-enforcing features that help to reduce evasion.<sup>1</sup>

Furthermore, the VAT, a sales tax that falls “indirectly” on people, was seen to be preferable to the “direct” income tax: “If developing countries are unable to make personal income taxes work effectively (because of tax evasion, accounting difficulties, long collection lags, and other enforcement problems), it may be the better part of

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<sup>1</sup> The general sales tax falls only on the sale of *final* goods and services. The VAT falls on the *value-added* of *all* sales of both intermediate and final goods and services. The VAT is implemented by fully taxing all sales. Tax refunds are then granted for taxes paid in earlier stages of production. However, in order to get the refund, the taxpayer must show a receipt for taxes paid earlier. Hence, the taxpayer insists that the taxes due in the earlier stages of production be paid, and that receipts for those taxes be produced.

wisdom to aim instead for the achievement of an efficient indirect tax system” (World Bank, 1991, p. 15).

Another recommendation for increasing revenue was to reduce the number of exemptions from the VAT. This would increase revenue by broadening the base upon which the tax would fall.

The WB’s advice for the VAT has been implemented. The VAT has been introduced into all Latin American countries (Tanzi, 1996, p. 24; CEPAL, 2006, p. 192). Furthermore, most countries increased the rate of the VAT between the time that it was first introduced and 1993 (Tanzi, 1996, Table 2.2, p. 25).

The preference for the VAT over the income tax is reflected in the relative growth in tax revenues. Between 1978 and 1988, the individual income tax revenues in Latin America rose from 1.6 percent to 1.7 percent of GDP, a 6.25 percent increase. The general sales tax and VAT revenues rose from 1.9% to 2.7% of GDP, a 42 percent increase (Tanzi, 1996, Table 2.1, p. 21).

### **The Individual Income Tax**

The advice for the individual income tax was to lower its maximum marginal rate to 30-to-50 percent, to reduce the number of exemptions, and to introduce a system of withholding (World Bank, 1991, pp. 5-6).

It was hoped that these changes in the individual income tax would increase revenue in several ways. Lowering the maximum marginal rate of the income tax was intended to reduce the incentive to evade the tax; less evasion, more revenue. Reducing exemptions would broaden the income tax base. Introducing withholding would help reduce evasion and assure timely payment of the tax.

### **The Company Income Tax**

The recommendation for the tax on company income was to set a single rate equivalent to the highest individual income tax rate, to reduce exemptions from the tax, and to establish a system of withholding (World Bank, 1991, p. 58).

The recommendation aims to increase revenue in much the same way that individual income tax revenues are increased. A single rate and withholding make both administration and compliance easier, and evasion harder. Reducing exemptions broadens the base upon which the tax is levied. Equating the company rate to the maximum rate on the individual income tax aims to reduce tax arbitrage in which persons exploit accounting procedures to shift the apparent sources of their incomes to low-tax sources.

## Critiques Of Tax Advice For Revenue

### **Regressivity**

The Latin American tax systems are thought to have been regressive before the implementation of the WB tax advice because most tax revenue is raised through regressive taxes. In 1988, progressive taxes generated revenue equal to 7 percent of Gross Domestic Product (GDP), while the revenue generated by regressive taxes equaled 9.6 percent of GDP (Tanzi, 1996, Table 2.1, p. 21).

The WB advises making Latin American tax systems still more regressive. Economic analysis shows that a general sales tax such as the VAT tends to raise prices by the amount of the tax, and so it is paid by the consumer. The tax is regressive because the poor are forced to spend virtually all of their incomes in order to survive, and so their entire incomes are taxed. The rich, on the other hand, can afford to save, and so they spend—and pay taxes on—only part of their incomes.

Lowering the maximum marginal rate of the individual income tax means that the relatively wealthy pay less tax. Between 1979 and 1991, the average maximum marginal rate fell from 48.1 percent to 35.4 percent in a sample of 18 Latin American countries. The average minimum rate fell from 7.1 percent to 6.5 percent (Tanzi, 1996, Table 2.3, p. 26). The average maximum rate fell by 36 percent while the minimum rate fell by only 9 percent. The relatively large decline in the maximum marginal rate makes the tax less progressive and the tax system more regressive.

Similarly, changes in the company income tax have made tax systems more regressive. Economic theory concludes that the company income tax is paid out of profits (Musgrave & Musgrave 1989, pp. 387-388). It tends to be a progressive tax because the company owners who receive the profits are relatively wealthy. In Latin America between 1980 and 1991, the average company income tax rate fell from 43.5 percent to 36.3 percent (Tanzi, 1996, Table 2.4, p. 27).

### **Short-run vs. Long-run Objectives**

The tax system recommended by the WB was intended to deal with the financial emergency that followed the international debt crisis. The problem is that the fiscal crisis of Latin American countries was a relatively short-term event. Unsustainable fiscal deficits and excessive inflation have been eliminated. On the other hand, poverty and inequality—as well as the domination, exploitation and exclusion that accompany them—have been going on for hundreds of years. The WB chose to focus on the short-term problem, and, in so doing, recommended a tax policy that obstructs the solution to the more serious long-term problem.

Would the fiscal crisis have been short-term without the WB tax advice? It might be argued that the fiscal crisis was a short-term event only because the regressive tax advice was instituted and thereby increased revenues. However, Tanzi shows that during the 1980s “tax revenues increased for the region as a whole, but not by large amounts” (Tanzi, 1996, p. 20). In 1980, tax revenue for all of Latin America was 16.8 percent of

GDP. while in 1988 it had only increased to 17.4 percent (Tanzi, 1996, Table 2.1, p. 21). The fiscal crisis seems to have been a short-term event for reasons other than raising tax revenues.

### **Lost Opportunity**

In failing to respond to the debt crisis more constructively, the WB let an historic opportunity to address the long-run problems of poverty and inequality slip through its fingers. The crisis itself gave the WB strong leverage over fiscal policy in Latin America because the region needed concessionary loans in order to work its way out of the debt crisis. For example, the region badly needed loans in order to invest in export sectors (Sachs & Larrain, 1993, Chapter 21). The WB could have used that leverage to help put the region on the path of progressive taxation for satisfying basic needs. Instead, it pressured countries to implement more regressive taxation.

## **Secondary Objectives and Tax Advice**

### **Second Objective: Efficiency**

The first “burden” of taxation is the amount of money that must be paid in taxes. “Excess Burden” is an additional social cost of taxation over and above the financial burden. It arises from changing behavior due to a tax. Because the sales of automobiles are taxed, I buy a Chevrolet instead of a Cadillac. The Excess Burden is the loss of satisfaction that comes from driving a Chevrolet instead of a Cadillac. An “efficient” tax system is defined to be a system of taxes that minimizes Excess Burden by minimizing behavior changes.

Economists have developed a Theory of Optimal Taxation that identifies the tax systems that minimize Excess Burden. Very importantly, the theory concludes that an efficient tax system is progressive: “The ‘optimal’ tax system is progressive” (Rosen, 2005, p. 343). “An interesting and important feature of optimal tax reforms is that they almost never endorse a uniform pattern of tax rates for either direct or indirect taxes” (Thirsk, 1997, p. 8).

### **Reinterpretation of Efficiency**

Despite the prescription of Optimal Tax Theory for progressive taxation, the WB recommends “uniform taxation” in the name of efficiency. Uniform taxation means that everybody pays, and that everybody pays the same tax rate. This contradicts Optimal Tax Theory’s prescription of progressive taxation. How did the WB go from progressive taxation to uniform taxation in the name of efficiency?

The WB’s first step is to argue that it is not practical to implement the prescriptions of Optimal Tax Theory: “information, administrative, and political requirements make it difficult to implement” an efficient tax system (Thirsk, 1997, p. 10).

The second step is to argue that country experience shows that efficiency can be improved by more uniform taxation: “All of the country studies adopt the rule of thumb

that the cause of economic efficiency is best served by a less differentiated pattern of effective income tax rates” (Thirsk, 1997, p. 10).

The idea is that past differences in tax rates were found to be inefficient. Some tax breaks that aimed to stimulate industrial activity were ineffective. Others were the result of corruption. “Most of the observed non-uniformity prior to reform has been found to be non-optimal and highly distorting” (Thirsk, 1997, p.10).

The third step is to reduce the concept of tax efficiency to mean nothing more than eliminating “non-optimal and highly distorting” rate differences. Instead of requiring the *progressive* taxation called for by Optimal Tax Theory, efficiency is reduced to meaning that “highly distorting” tax differences are eliminated.

### **WB Tax Advice for Efficiency**

Having redefined “efficient” taxation as “uniform” taxation, the WB finds that happily the tax advice for increasing revenue also improves “efficiency.” The VAT enhances uniformity if it replaces “cascade” sales taxes. Cascade taxes fall upon the full value (not just the value added) of all sales, both intermediate and final. If one product passes through five stages of production while a second product passes through three stages of production, the first is taxed five times and the second is taxed three times. This distorts relative prices and changes taxpayer behavior.

Uniformity is also enhanced by reducing exemptions from the VAT and by using only a few VAT tax rates. Taxing the sales of all items more equally helps to assure that everybody pays and everybody pays the same amount. Reducing the number of tax rates reduces variations in payments between individuals. It also simplifies administration and helps to avoid differences in payments arising from administrative error.

Lowering the maximum marginal rates of the income taxes makes taxes more uniform if the policy reduces tax evasion. Reducing the spread among rates reduces the dispersion of tax payments between individuals. Similarly, reducing the number of exemptions from income taxes and implementing withholding helps to assure that everybody is treated the same way.

### **Critiques of Tax Advice for Efficiency**

#### **The Correct Policy for Excess Burden**

Eliminating “highly distorting” tax differences is good tax policy. However, efficiency is further enhanced by instituting the tax differences that reduce distortions in behavior. The correct policy is not to just eliminate inefficient differences. The correct policy is to eliminate inefficient differences *and* to institute efficient differences in taxation.

#### **Optimal Tax Prescriptions are Feasible**

The WB discards the progressive taxation prescribed by Optimal Tax Theory as impractical because of the information, administrative, and political requirements.

However, Newbery and Stern (1987) have found that the necessary data are available and can be used to identify optimal commodity tax reforms (cited in Thirsk, 1997, p. 9). If they are correct, the information and administrative requirements are not prohibitive. However, as discussed below, the political requirements may be more daunting.

### **Basic Needs as Efficient**

The normal interpretation of Excess Burden is not a sufficient criterion of efficiency. The normal interpretation of the concept does not take into account the inefficiency of rendering a large portion of the population unproductive through failing to satisfy its basic needs. Uniform taxation is inefficient, not only because it fails to satisfy the normal dictates of the Optimal Tax Theory, but also because it leads to regressive taxation that obstructs the satisfaction of basic needs and the implementation of an inclusive development process.

In other words, the normal interpretation of Excess Burden should be broadened to include a very important and specific change of behavior: people not participating in the development process. Uniform taxation generates this type of Excess Burden through imposing regressive taxes on the poor that lower their productivity and the possibility of participating in the production process according to their potential.

### **Forced Reinterpretation of Efficiency**

The real world circumstances pressing for tax reform (debt crisis, fiscal deficits, inflation) demanded revenue above all else. Once the WB adopted the primary objective of raising revenue and the policy of raising it through regressive taxation, it was forced to water down the concept of efficiency until it meant nothing more than eliminating highly distortionary tax policies. Evidence that the prescription of Optimal Tax Theory could be implemented had to be overlooked because the prescription was for progressive, not regressive, taxation.

## **Third Objective: Administration**

### **The Rationale**

Tax administration—not tax law—is *de facto* tax policy. A country can have an ideal tax system on the books, but poor administration can cause the system to diverge greatly from the ideal. Because tax administration in developing countries reportedly suffers a “grave lack of capacity,” an important task is to improve it (Thirsk, 1997, p. 10).

### **Tax Advice**

The first recommendation is to simplify the administrative task. Once again, the tax policy for raising revenue helps to simplify tax administration. The VAT has a self-enforcing feature. Lowering the maximum marginal rates of the income taxes supposedly reduces attempts to evade. Reducing the number of tax rates and the number of exemptions makes it easier to calculate taxes due.

The second approach is to improve administrative capacity. Recommendations include implementing computerized information systems, training the staff, and raising salaries in order to attract more capable personnel.

### **Critique of Administration Advice**

Administrative improvements are of course welcome. The trouble is that after adopting the VAT as the principle source of tax revenue, administrative reform naturally focuses on implementing that regressive tax. A much better way to implement an inclusive development process would be to focus administrative reform on learning to implement progressive income and wealth taxes more effectively.

### **Fourth Objective: Equity**

The fourth objective adopted by the WB is fairness in taxation. Economists define two types of tax equity. The first, called Horizontal Equity, means that all persons with the same income pay the same tax. The second, Vertical Equity, means a fair distribution of taxes between persons of different income classes.

### **Tax Advice for Equity**

Once again, the advice for achieving equity is largely the same as that for raising revenue: institute the VAT, lower the maximum marginal rates of the income taxes, establish income tax withholding, and reduce the number of exemptions from both taxes.

The WB considers this advice fair because it enhances Horizontal Equity. Lowering the maximum marginal rates of the income taxes supposedly reduces evasion and thereby causes everybody with the same income to pay the same tax. Withholding encourages timely payments by all, and it may help to reduce evasion. Eliminating exemptions and instituting withholding for the income taxes serve the same purpose.

Unfortunately, the advice for achieving Horizontal Equity leads to more regressive taxation and less Vertical Equity. The WB attempts to salvage some Vertical Equity in the VAT by recommending that items consumed by the poor such as non-processed food be exempted, and that relatively high tax rates be imposed on the sales of luxury items consumed by the wealthy. Thirsk, however, recommends against taxes on luxury items “because it complicates the administration of the VAT and is an example of poor targeting between tax instruments and objectives” (Thirsk, 1997, p. 21).

In the case of the individual income tax, the advice is to exempt persons with very low incomes from the tax and to eliminate loopholes that benefit the rich (World Bank 1991, pp. 60, 72).

## Critiques of Equity Advice

### Horizontal Equity

Despite the recommendation to reduce exemptions from the individual income tax, exemptions have not fallen but rather increased sharply since the early 1980s. Shome estimated that the share of exemptions in per capita income rose on average from 0.45 percent in 1979 to 1.62 percent in 1991 (Shome, 1992, cited in Tanzi, 1996, p. 27). The jury is still out on whether the WB's assumption that lower maximum marginal rates of the income tax reduces evasion.

### Vertical Equity

The WB's policy of exempting items consumed by the poor from the VAT has not worked well in practice: "None of the reforms examined appear to have achieved notable success in reducing indirect tax burdens on the poor, although . . . most countries try to remove some of the VAT burden on the poor by either exempting or zero rating unprocessed food products" (Thirsk, 1997, p. 24).

The second way of salvaging some vertical equity is to exempt very low incomes from the personal income tax. This advice probably has almost no effect on Vertical Equity because most of the personal income tax is paid by public employees and employees of large firms, virtually all of whom are non-poor (World Bank 1991, p. 16). The poor tend to work in the informal sector that the income tax does not reach. The net result is that the WB's tax advice virtually abandons Vertical Equity.

### Spending But Not Tax Equity?

Having abandoned Vertical Equity in taxation, the WB searched out another strategy for coping with Latin America's poverty and inequality. The strategy is to rely on the expenditure side of the budget to satisfy equity concerns: "It may be the better part of wisdom to aim instead for the achievement of an efficient indirect tax system and use its revenues to finance targeted subsidies for the poor" (Thirsk, 1997, p. 15).

If the oligarchs of Latin America cannot be made to tax progressively, what is there to cause them to spend progressively? Would they not prefer to spend the regressive tax revenues on items that directly serve their own interests? The WB seems to assume that good will exists among the oligarchs on the expenditure side of the budget, but not on the tax side. The assumption appears naive given that the recommended tax policy strengthens the wealth and power of the oligarchs and thereby makes it even less necessary than before to show largesse on the expenditure side of the budget.

Empirical data support this view. A review of tax reform in Latin America conducted by the Inter-American Development Bank (IB) and published in 1996 found that, despite "the urgent need" to increase spending for basic needs, it had not been done:

Recent reforms sought to improve tax collection by increasing the neutrality of the tax system, complemented by a reform in government spending to meet the needs of the poorest groups more efficiently. Nevertheless, spending reforms have lagged, and in fact

the vertical equity of state intervention in Latin America could be seriously questioned (Inter-American Development Bank, 1996, p. 7).

Similarly, the World Bank found that “between the mid-1980s and mid-1990s, public spending on education and health increased in a large number of low-income countries, though slowly” (World Bank 2001, p. 82). Furthermore, within each of these sectors, the spending often benefits the rich far more than the poor (World Bank 2001, p. 80). In 1993, only 9 percent of Nicaragua’s education budget benefited the poorest quintile of the population, while 40 percent of the budget benefited the richest quintile (World Bank 2001, Table 5.1, p. 80).

### **Feasibility of the Income Tax**

The WB assumption that progressive taxation and vertical equity are not possible in Latin America is highly questionable. What if Mahatma Gandhi or Martin Luther King or the Wright Brothers or NASA—all of whom started out confronting seemingly insurmountable obstacles—had made this assumption? The WB’s assumption risks becoming a self-fulfilling prophecy and permanently condemning Latin America to the poverty and inequality that afflict the region.

Vito Tanzi, the Director of the Fiscal Affairs Department of the International Monetary Fund, writes that the argument that the personal income tax cannot be achieved “is not very convincing,” since in fact the income tax is used extensively in several developing countries to raise social security contributions (Tanzi, 1996, p. 26).

He also finds that in Latin America “these taxes remain underexploited, generating revenues that are much lower than in other (developing) regions” (Tanzi, 1996, p. 26). He concludes: “Should Latin America need to raise the level of taxation much above its current level, this will be the place to look” (Tanzi, 1996, p. 26).

We will see below that Presumptive Taxation in which the income tax is based on simple indicators other than income is a feasible means of increasing the use of the personal income tax immediately and a feasible means of growing into a wider use of a full-fledged income tax. A number of developing countries currently use Presumptive Taxation, and its further use is encouraged by the WB (World Bank 1991, pp. 38-40; Thirsk, 1997, p. 10).

### **Equity as Inclusive Development**

In setting the objective of tax equity, the WB adopts the traditional meaning of the term which is simply a “fair” distribution of the tax burden. Fairness alone is an abstract, ill-defined concept that has never been the politically most compelling objective. “Fairness” is easily relegated to second or even to last place.

In the economic context of Latin America and other developing countries, the traditional concept of equity should be broadened to include “inclusive development.” The majority of Latin Americans need more than abstract, ill-defined “fairness.” They need the opportunity to earn a living through participation in the production process.

That opportunity is given in part through satisfying basic needs through progressive taxation.

One senses that the WB simply adopted the Musgraves' concept of equity listed in their "requirements of a 'good' tax structure." The Musgraves wrote their "requirements" with developed countries—particularly the United States—in mind. It is disheartening that the WB—whose very mission is development—failed to broaden the traditional interpretation of "fairness" to incorporate its mission. The WB tax advice seems oblivious to and indifferent about instituting a fair development process.

The abandonment of Vertical Equity is especially disheartening in the context of the extreme inequality that afflicts Latin America. J. L. Londoño finds in a study of 102 countries that on average a Latin American country is significantly more unequal than other countries with similar incomes (Londoño. 1996, pp. 3-4). A study by Székely and Hilgert, and another by John Scott, concluded that Latin America is the most unequal region in the world (Székely & Hilgert, 1999, cited in Franco, 2003, p. 355; Scott, 2001, p. 14). This extreme inequality is precisely the situation in which progressive taxation is most fair.

### **Forced Reinterpretation of Equity**

It is remarkable that an institution whose very mission is development would recommend the virtual abandonment of Vertical Equity for a region plagued by poverty and inequality. How did the WB come to this point? The answer is easy to find. Once the WB committed itself to raising revenue through regressive taxation, it was forced to virtually abandon Vertical Equity. All that could be done was to focus on Horizontal Equity and to make a few feeble gestures toward Vertical Equity.

### **Implied Development Strategy**

The tax changes in Latin America that followed the WB tax advice open a small window through which one may glimpse the political reality of the region. The oligarchs who control the countries have generally adopted the tax advice that is favorable to themselves and ignored the advice that is not. The WB recommended the regressive VAT as the preferred source of revenue. It was introduced and emphasized in all countries. The WB recommended lowering the maximum marginal rates of the income taxes on the wealthy. The average maximum rates were speedily reduced.

In order to preserve a semblance of Vertical Equity, the WB recommended that items consumed by the poor be exempted from the VAT. The few exemptions that were granted failed to reverse the regressivity of the tax change. The WB recommended that arbitrary and ineffective exemptions from the personal income tax be eliminated. Not only have they not been eliminated, they have been increased. The WB recommended that the loss of Vertical Equity be compensated on the expenditure side of the budget. It has not been done.

This is a classic example of what the WB calls a “pathology of policy design.” It is the pathology associated with “oligarchic dominance—institutions and policies that further the interest of elites but not those of the whole society.” Where the pathology of oligarchic dominance exists, political action has often been biased against poor or lower-status groups (World Bank, 2005, pp. 129-130).

The WB tax advice has tragic implications for the development process. More regressive taxation deepens the pathology of oligarchic dominance by strengthening the wealth and power of the oligarchs. What kind of development process do newly empowered oligarchs want? Is it not the traditional trickle-down approach led by a few *patrones*? Is it not more of the same: “I lead, you follow?”

### **Alternate Tax Structure**

If following the WB tax advice obstructs inclusive development, what should be done? The broad answer is to move toward progressive taxation in order to facilitate the rapid satisfaction of basic needs. Claudino Pita of the Inter-American Development Bank wrote that in the future, it will be necessary to “take more into account the distribution of the tax burden, in order to avoid . . . the regressive effects that significantly diminish the impact of social programs . . . .” (Pita, 1993, p. *iv*).

A full treatment of the many ways in which Latin American tax systems can be made more progressive is beyond the scope of this paper. However, increasing the use and the progressivity of the personal income tax is a prime candidate.

Theoretically, the personal income tax is the best of all taxes. Its virtues include being an excellent source of revenue, an effective means of minimizing Excess Burden, and an excellent instrument for redistributing income. Through exemptions and deductions, the tax can be personalized to fit the circumstances of the taxpayer. The most difficult part of the income tax is to administer it. Incomes must be measured, and this requires substantial information and a sophisticated accounting system.

The grandfather of public finance, Richard Musgrave, pioneered an approach to establishing the income tax in developing countries when he served on a consulting mission to Bolivia. His approach is called “Presumptive Taxation” (Musgrave, 1981).

Instead of measuring individual incomes, presumptive taxation “presumes” a level of income on the basis of indirect, easily measured indicators. For example the income of professionals like doctors can be “presumed” on the basis of the number of secretaries, office space and other indicators. The income earned by the owners of large agricultural farms can be presumed on the basis of regional fertility, size of holdings, etc.

Persons are required to pay at least the tax based on presumed income. A system of appeals is established in which persons may have their taxes lowered if—and only if—they provide full documentation that proves that their income was less than the presumed level. This documentation helps to move countries toward a regular income tax. More

broadly, the expertise developed in applying Presumptive Taxation is expected to move countries step-by-step toward a full, progressive income tax.

Other attractive options for enhancing the progressivity of the tax system include a *national* property tax and an inheritance tax. Alan Tait wrote that wealth taxes are a powerful engine for change:

Such a tax alters the very stuff of society: the family, death, and the historical continuity of houses, land, and all personal property. Wealth taxes alter the relations of groups and persons in the social hierarchy . . . Excise taxation seems almost frivolous by comparison (Tait, 1967, p. 1).

A third policy is “tax-sharing” in which the federal government collects the taxes and redistributes the revenues to state and local governments (McGuire 2005, Chapter 5). It is difficult for local governments to implement progressive taxation because the attempt tends to be undermined by wealthy taxpayers moving out of the locality and poor persons moving in. The solution is to have nation-wide progressive taxes collected by the central government and to have the tax revenues distributed by the central government to state and local governments.

The most difficult hurdle to progressive taxation is probably not technical but rather political. The first responsibility for bringing the required pressure to bear on governments to move toward satisfying basic needs through progressive taxation lies with the citizens of developing countries. The recent swing toward “leftist” governments in Latin America suggests that the citizens may be accepting that responsibility.

The second responsibility lies with the outside world and with international organizations such as the World Bank. Strong outside pressure is needed to overcome the deeply entrenched domination by Latin American oligarchies. The World Bank in particular should accept its responsibility to bring pressure to bear on the governments of Latin America to institute the progressive taxation and to use the revenues to satisfy basic needs. This is the best road to inclusive development and to solving the problems of poverty and inequality that afflict Latin America.

## **Conclusion**

The mission of the WB is “global poverty reduction and the improvement of living standards” (World Bank, 2006b). The WB has taken steps to complete its mission, not the smallest of which is ground-breaking research on the Basic Needs Approach to Development (see, for example, Streeten et al., 1981; Stewart, 1985; Hicks, 1979). Unfortunately, the tax advisors of the WB are working at cross-purposes with other WB efforts to carry out the mission.

In order to quell the Latin American debt crisis, the tax advisors adopted as their primary objective raising revenue quickly and easily. Given that Latin America is the most unequal region of the world and that poverty is rampant, the natural inclination is to try to raise revenues through progressive taxation. However, past attempts to tax

progressively had seemingly failed. Consequently, the WB assumed that tax revenues could not be raised quickly enough through progressive taxation.

Therefore, the WB gave advice that seems strange for an institution with a mission to foster development of poor and unequal regions. It opted for more regressive taxation. The main advice was to adopt the VAT and to lower the maximum marginal rates on the income taxes.

The stance in favor of regressive-taxation-for-revenue pushed the WB to water down the traditional concept of efficiency until it meant nothing more than eliminating the grossest inefficiencies of the current tax systems—exemptions from the income taxes that had been granted as misguided attempts to stimulate sectors of the economy or as political favors. The governments ignored this advice and even increased the number of exemptions.

Next, the WB was pushed to dismiss the prescription of Optimal Tax Theory for progressive taxation. The WB argued that implementing the prescription was not practical because of information and administrative requirements even though empirical work finds that it is practical. More compelling is the WB's argument that the political reality of Latin America obstructs progressive taxation.

In its haste to raise revenues, the WB was pushed to overlook the full meaning of efficiency. Efficiency in the fullest sense of the word includes providing the opportunity for the countries' most important resources—the human resources—to realize their productive potential. Having the productive potential of the majorities of populations stifled by failing to satisfy basic needs is inefficiency at its worst. One might have thought that the agency whose very mission is development would have been the first to recognize this and to recommend progressive taxation in order to combat it.

After committing to the VAT as the preferred tax, administrative reform naturally focused on implementing this regressive sales tax rather than progressive income and wealth taxes. This led to a more intensive use of the regressive VAT and a relative neglect of progressive taxes.

Perhaps the saddest part of the WB tax advice appears in the realm of equity. Horizontal Equity is trumpeted insofar as it promotes the primary objective of raising revenue. Vertical Equity is virtually abandoned precisely in the region of the world where it is most lacking. Sadder still, the WB has yet to move beyond viewing equity as mere fairness and to see equitable development as an essential objective of tax policy.

The advice for regressive taxation has not raised revenues significantly. Fiscal deficits and inflation have been reduced to manageable levels, but for other reasons such as cuts in expenditures. The WB largely failed to achieve its objective of raising revenues through taxation, but its abortive attempt saddled Latin Americans with still more regressive tax systems that will be difficult to throw off.

The more regressive tax systems have deepened the “pathology of oligarchic dominance,” by enhancing the wealth and power of the oligarchs. This prolongs a top-down approach to development, and it obstructs the inclusive development process that seems to be the best way to cure the plague of poverty and inequality in Latin America.

The tax advice of the WB pays inadequate attention to the political reality of Latin America. An awareness of the reality surely played an important role in making the assumption that progressive taxation cannot be instituted in Latin America. But the reality is forgotten when the WB casually assumes that even though the oligarchs will never tax themselves progressively, they will spend the ill-gotten revenues to benefit the poor. Not surprisingly, studies find negligible increases in spending on basic needs that benefit the poor.

The pathology of oligarchic dominance points to the necessity of bringing outside pressure to bear on the Latin America to both tax and spend in ways that generate an inclusive development process. The WB failed to seize the opportunity provided by the debt crisis to successfully bring that pressure to bear on oligarchs. Instead, it appears to have unwittingly become a collaborator with the oligarchs in reinforcing top-down approaches to development. Tax systems are not easy to change. The WB will have to redouble its efforts in order to undo the damage.

The political reality of Latin America shows that the tax advice of the WB suffers from a fundamental methodological flaw. The methodology is to examine Latin American experience and to derive “Lessons” for the future from that experience. The tax history of Latin American oligarchs does not provide a legitimate basis for tax advice.

In 1992, the WB wrote that “The achievement of sustained and equitable development remains the greatest challenge facing the human race:” (World Bank, 1992, p. 1). Latin America waits for the tax office of the WB to put these words into practice by taking off its blinders—especially with respect to the political realities of Latin America; by broadening its perspective—especially to see the important role of taxation in instituting an inclusive development process; by reforming its tax advice—especially to emphasize progressive income and wealth taxation; and by enforcing that advice with vigor.

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