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# Rebuilding state capacity in contemporary Latin America: The politics of taxation in Argentina and Mexico

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# REBUILDING STATE CAPACITY IN CONTEMPORARY LATIN AMERICA: THE POLITICS OF TAXATION IN ARGENTINA AND MEXICO

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## INTRODUCTION

During the 1980s and the early 1990s, Argentina and Mexico underwent a sweeping reformulation of tax institutions which led to the strengthening of state capacity and enforcement mechanisms. As a consequence of those reforms a new awareness towards taxation has emerged as people's perceptions and attitudes towards taxation have changed dramatically. Under the previous tax system, payment was considered foolish; both firms and individuals tried to evade paying taxes as much as possible. In contrast, under the new system, payment is considered at least inevitable as the tax base has been enlarged and enforcement mechanisms substantially improved. I claim that due to this institutional transformation, state capacity in both countries has been improved. By state capacity, I mean the state's ability to implement its own goals (including the creation and restructuring of political and social institutions) in the face of opposing actors and adverse conditions (Nordlinger 1981; Skocpol 1985; and Knight 1992).

However, the two dominant approaches to the study of economic restructuring in Latin America lead us either to encourage and embrace or to expect and fear the existence of a weak state. On the one hand, neo-liberalism asserts that since the market is the most efficient mechanism for allocating resources, economic reforms should consequently aim at eliminating state interventionism and even most of its regulatory capabilities (Willamson 1990).[2] On the other hand, excessively broad assessments of the impact of structural adjustment and/or ideologically-driven, melancholic judgements opposing economic reforms argue that they have been causing the destruction of the state and the dismantling of its institutions. Moreover, it is argued that a supposedly powerless state apparatus not only would be ineffective in checking the behavior of powerful private interests, but also would be incapable of avoiding "market failures". Then, the new state would ultimately provoke negative effects for economic development, social justice, and political stability.[3]

As it is currently defined, this manichean debate surrounding neo-liberalism lacks what I consider a theoretically more illuminating, empirically relevant, and politically crucial issue: *the actual institutional design of the states emerging from economic restructuring* which in the case of Argentina and Mexico, and regarding taxation, present a sweeping reformulation.[4] It is time to move beyond this relatively narrow debate to focus on topics and cases that should help us to understand what particular kind of state institutions are in fact being created after, and indeed as a consequence of, the process of structural adjustment. Moreover, I think that focusing on the nature and logic of institutional reforms as well as on the emerging design of the state provides interesting insights in assessing the role of the state in the era of globalization. It is usually argued that in particular due to the impact of financial liberalization, nation-states no longer have enough capacity or resources to regulate the economy. Although this may be the case with regard to capital flows and short-term portfolio investments, the experience of Argentina and Mexico suggests that states still have an important role to play. They retain the ability to reform themselves, to change economic and political institutions, and therefore to affect economic and political outcomes. Furthermore, I think that, along the lines of the old controversy between domestic and systemic/international factors in shaping political outcomes, the world system perspective should give enough importance to the still significant ability of domestic actors to develop and recreate institutions, thus changing the distribution of resources in society.

In this paper I present the preliminary findings of ongoing research on the politics of taxation in Argentina and Mexico since 1982. In both countries, the debt crisis triggered a long, complex, and conflictive process of thorough fiscal reform regarding revenue and expenditure.[5] These reforms were applied during the wave of stabilization and structural adjustment programs monitored by international financial institutions (IFI) such as the International Monetary Fund (IMF) and the World Bank (IMF 1990; World Bank 1991). The paper is divided in three sections. First, I analyze the politics of taxation in both countries until the 1980s. Then, I focus on the emerging tax structure. I refer to both material and symbolic transformations presented by the new tax system as compared to the previous one. Finally, I ponder spill-over effects the new tax structure may provoke, and its implications for the emerging political matrix in both countries. In addition, I consider the significance of these experiences in assessing the role of the state with regard to the world-system perspective.

## I. THE POLITICS OF TAXATION UNTIL THE 1980S

Until the wave of fiscal reforms that started in the 1980s, Argentina and Mexico (and many other Latin American countries as well) relied only partially on taxation as a way to collect revenue. Other means such as tariffs on imports and exports, foreign and domestic debt, and the inflationary tax were considered to be politically less costly than collecting revenue through a workable, efficient tax system. Although a myriad of taxes on income, sales, and property did exist, very inefficient administrative procedures and enforcement mechanisms made taxation almost irrelevant. As was the case in many other sectors of the state apparatus, it was very easy for private interests to find veto points through which to create and/or defend rents. Corruption was generalized, tax agencies and their personnel had an extremely bad reputation, and many failed attempts to change this situation created the idea that having a sound tax system was indeed utopic.

Thus, measures of tax collection as a proportion of GDP show the weakness of formal taxation in Argentina and Mexico (see tables I and II). But figures tell just part of the story, as it is not only important to consider how much a state can raise, but also its method of doing so. Indeed, the institutional framework that regulates taxation has profound consequences as far as redistribution, growth, savings, etc. (Steimmo 1993). In Argentina and Mexico, the prevailing tax institutions created wrong incentives for societal actors in a typical vicious circle fashion. The state proved to be weak and incapable of creating an efficient tax system, or even enforcing existing regulations. Thus taxpayers found it easy, and relatively safe, to evade and/or elude their dues. Although individually it was rational to act in such a way, the aggregate effect was very harmful for society, in a textbook case of a collective action problem.

Fragile public finance caused macroeconomic instability and inflationary spirals, mainly in cases of external shocks. Then interest rates would rise, making the financial cost of compliance much higher. Uncertainty and the expected drop in economic activity would prompt cautious crisis-management strategies for both firms and individuals. Therefore, firms evaded taxes in order to avoid cash-flow shortages. Lack of effective enforcement capabilities and the certainty of an eventual tax forgiveness provided incentives for such behavior. The only possible risk was having the business inspected by the taxman. But, as corruption was truly generalized, there were many ways to "persuade" them to overlook tax records. Accordingly, as paying taxes was anything but a priority, firms and individuals would rather allocate their money in safer, more logical and profitable manners, such as the purchase of hard currency, or speculation in the risky but lucrative domestic financial system. In any case, it is apparent that bureaucrats and the rich and powerful dominated this game, while both the state and ordinary people had a meager, passive role.

That complex and deficient tax system was not only the result of poor technical designs. Rather, private actors found it possible to lobby in order to protect their interests due to the existence of "permeable" political regimes. Moreover, taxation was just one of the means through which private interests would create and perpetuate rents, the others being trade, financial, monetary and social policies. Under the ideological umbrella of nationalism, protectionism, infant industry, etc., both labor and capital utilized their power and/or ability to mobilize workers as tools to shelter not only their constituents' interests, but mainly their corporatist privileges.

This story may sound inconsistent with the portrait of a state that since the crisis of the 1930s, and until the 1980s, had a major role in Latin America. However, problems such as improper institutional designs, administrative incapability, and poor enforcement mechanisms also affected other areas of state involvement. In other words, it was the political regime as a whole that was misconceived. Let me now make some general references regarding the nature of this political regime.

As Cavarozzi (1991, 1992, 1994) has argued, since the 1980s the more industrialized Latin American countries have been suffering a crisis of their state-centered economic and political matrix (SCM) which was established in the 1930s and 1940s. In this matrix the state played a major role as an agent of accumulation, redistribution, modernization, and incorporation of new social and political actors, thus managing social conflicts. A complex, sometimes chaotic fabric of economic and political institutions was established by and around the state, which was controlled by new and old political elites, depending on each country. The SCM remained basically the same under both authoritarian and democratic regimes. It was able to survive as long as the state had sufficient political and economic resources to respond to domestic social demands and to changes in the international system as well, including external shocks. Among those resources I will stress the capacity to finance expenditures through inflationary taxation, debt, and the improper use of public assets, funds and savings that were originally earmarked for other purposes (e.g., the public retirement system in Argentina; oil related revenue in Mexico). Although by the mid-1970s the SCM already displayed obvious symptoms of exhaustion, the debt crisis which exploded in 1982 delivered the final coup de grâce. Until then, the SCM proved hard to change as entrenched groups and dominant actors managed to reproduce their interests. In this kind of inflationary environment, there was a concentration of income in the highest percentiles of the population, as there was a transfer of resources from fixed-income sectors (e.g., labor, retirees).[6]

Inflationary financing replaced taxation as a central tool for collecting revenues. Thus, labyrinthine tax laws and inadequate enforcement mechanisms fed a vicious circle which, along with the debt crisis, eventually ended in dramatic fiscal disasters. Then, it was the public sector which not only suffered the consequences of high-inflation, but also perpetuated it. As Olivera (1967) and Tanzi (1977; 1978) demonstrated, lags in tax collection strongly influenced real revenue due to the constant depreciation of the currency and the lack of sound mechanisms for indexation. In addition, the incapacity to improve tax administration was a key factor in reproducing the weakness of the state, especially due to the lack of enforcement mechanisms and the existence of unscrupulous inspectors. Indeed, there were clear incentives for inspectors to behave in this particular manner, and for people to behave illegally as well. Salaries were low, no one really supervised inspectors' duties, and the profession lacked prestige altogether.[7]

The state nourished this vicious circle not only by inflationary financing and by not being able to improve enforcement mechanisms and institutions, but also by engendering the personnel in charge of administering and innovating that perverse system: the CPAs. Almost exclusively graduates of free, public schools, CPAs had a crucial role in this game, which was certainly not only limited to the prosperous business of advising firms on the best way to evade taxes. Actually, the practice of "double-accounting" was very extensive and quite sophisticated. It meant having the administration of a business divided between a "white", legal and taxable part, and a "black", illegal and non-taxable part. In order to operate in this manner, a complete double system was needed, including banking accounts, stub books, receipts, etc.[8] In many cases CPAs completely invented the figures with which tax returns were completed.[9]

Until the 1980s attempts to change this absurd system failed repeatedly. Political and social actors involved in the tax process found it convenient not to substitute the existing tax structure for a more serious, efficient one. Ruling elites, both authoritarian and democratic, preferred the inflationary tax to any other open and formal revenue collecting strategy. Or, they tried to implement stabilization policies which ultimately failed due to the opposition of political and social actors. In any case, ruling elites transferred the costs of such a strategy to future generations, a logical decision in unstable political environments like the ones that prevailed elsewhere in Latin America. Setting up a sound and efficient tax system was considered almost impossible, worthless, and silly for people who priorized short-term goals and benefits.

Firms and individuals also preferred inflationary taxation as alternative means were perceived to be more costly. As long as levels of inflation were not extremely high, and as long as economic growth continued despite (and, to some extent, thanks to) inflation, there were not strong incentives for economic agents to modify their behavior. Rather, economic agents developed quite sophisticated strategies to deal with inflation (e.g., indexation of contracts, ingenious financial tricks) which ultimately decreased the costs of operating in those environments. However, when inflation and macroeconomic instability went completely out of control, all those strategies proved to be ineffective, and consequently actors' preferences finally changed. Until then, anti-inflationary policies were unpopular, preventing democratic and authoritarian administrations from actively supporting them.

Until the 1980s, taxation in Argentina and Mexico was actually a facade behind which powerful interests were protected. Instead of allowing the public sector to effectively collect revenue, both countries' institutional design actually promoted tax evasion. For social and political actors, taxation was not in fact an important concern. Existing tax regulations and agencies were powerless and very vulnerable. Electorally speaking, taxation was an insignificant item as nobody would have been seduced by a candidate that would have addressed a non-issue. For the private sector, easy ways to elude and/or evade tax dues certainly existed, which were openly known and institutionalized through astute, imaginative mechanisms. This certainly absurd system was ultimately based upon a complex set of economic and political institutions -the SCM- which managed somehow to reproduce itself until the 1980s.

Since the onset of the debt crisis, the resulting (and unprecedented) fiscal crisis of the state completely altered the prevailing politico-economic scenario in both Argentina and Mexico. During the 1980s, sooner in Mexico than in Argentina, a new set of ideas, perceptions, values, options, constraints, and priorities gained momentum as inflation was considered to be truly harmful to society for the first time in the contemporary history of both countries.[10] Moreover, macroeconomic stability was considered a public good, and the price to achieve it (whatever it would be) worth paying. As fiscal responsibility then became a crucial electoral issue, political elites found it necessary to rebuild the state apparatus from the bottom up. They started by destroying the most burdensome part of it (e.g., state-owned enterprises, industrial "promotions" and other subsidies), and by redefining basic institutions such as tax agencies and laws.

## II. UNTOUCHABLES AND TERRORISTS

If not completely the opposite, certainly a very different situation currently prevails in both countries. A series of tax reforms dramatically affected people's attitudes about taxation. Moreover, the former consensus on the weakness of the state, in particular on the integrity of inspectors (or lack thereof), is gone for good as changes in staff recruiting, training, wage policy and promotions have significantly reversed inspectors' spirit and behavior. They now have a new group identity, a novel loyalty to their agencies, and also a transparent goal: they consider themselves the crusaders of public finance, the troops of the modernization process.[11]

Symbolic changes and mass media campaigns have helped to create a new sense of transparency and visibility for tax institutions. For instance, in Argentina the new headquarters of the main tax agency, the DGI (Direccion General Impositiva), is now located just in front of the Plaza de Mayo, Buenos Aires' main square. According to Spanish tradition, the headquarters of the most important institutions of society were located around the city's main square. In addition to its new location, the DGI now has a new elite corps of inspectors and investigators, a kind of SWAT team of tax enforcement, who are popularly known as "The Untouchables", after the celebrated show about Chicago, the mafia, and the group of honest cops led by Mr. Elliot Ness. This selected group has a solid reputation in society: they are respected and even feared. Moreover, the fact that those inspectors are called "The Untouchables" strongly suggests that organized crime still threatens Argentina, as was the case in Chicago in the 1930s. Indeed, the metaphor works very well as although many efforts have been made to enforce tax laws, evasion has not yet been completely eliminated.

Tax agencies are struggling to further decrease evasion and to identify sectors that are still committing fraud and even crime. But in both countries, the former notions that taxation is not important, that inspectors can be easily bought, that the tax administration is a mess, have disappeared. Tax revenue has increased, and as important as the figures themselves is the fact that now tax authorities and institutions are very visible to society. People do care about taxes; political parties and social actors are also very concerned about taxation. And the very notion that tax policy can eventually become an electorally hot issue means an authentic revolution for both countries' political culture.

But figures matter. In Argentina, as Durán and Gómez Sabaini (1994) report, tax collection increased 200% in real terms between the third quarter of 1991 and the fourth quarter of 1993. Table I also reports that in less than three years the deficit of the public sector (4.2% of GDP in 1989) turn into a surplus (0.3% of GDP in 1992). Also, note that by 1992 total revenues reached a peak of 17.5 % of GDP, the highest level in ten years. Gil Díaz (1993) reports that in Mexico the tax burden increased as much as 30% from 1988 to 1991 as tax revenues (excluding oil) grew from 9.3% of GDP in 1988 to 10.8% of GDP in 1991. In that period, the number of taxpayers increased 31.7%; excluding employees, the enlargement of the tax base reached an impressive 87.2% (Gil Díaz 1993).[12] Table II also shows that by 1991, not only was the deficit eliminated but until 1994, surpluses were achieved.

The constant presence of tax agencies is now maintained mainly through media campaigns, announcements by mail, and inspections. Also, tax agencies regularly issue a list of firms and individuals that are being prosecuted for ignoring regulations and/or breaking the law. And although judicial processes are still too long and intricate, some people has been incarcerated and many firms have been forced to pay their dues after proper investigations have been carried out. The "strong hand" policy of the Argentine and Mexican tax agencies has rendered obvious results, although some people complain that this visible hand of the taxman is too rough.

It is argued that, in some cases, investigations are not carried out properly as inspectors and tax agencies do not correctly observe some regulations. Therefore, authoritative procedures become rather authoritarian ones. As the new system is still to be further improved, some procedural flaws may exist.[13] Although some wrongdoing may have occurred, the bottom line is that invigorated state institutions have prompted serious resistances from affected sectors. Thus, in 1989, after new taxes had been included in the 1990 budget, powerful business associations publicly accused Francisco Gil Diaz, then the Mexican Undersecretary of Public Finance, of committing "fiscal terrorism".[14] That is to say, a civil servant whose aim was to enforce the law that the Mexican Congress had passed was considered to be a fiscal terrorist.[15]

But the effort of the Untouchables, the fiscal terrorists, and the respective economic teams that have been working very hard to improve taxation in Argentina and Mexico has rendered outstanding profits. Thus, there is evidence that the "black", informal economy shrunk significantly as enforcement capabilities expanded, although it is still a problem particularly in big urban conglomerates. In addition, the role of CPAs has changed as, according to new regulations, they are now the key link between the state and the taxpayers regarding the communication of information to tax agencies. In both countries, major taxpayers' information now has to be delivered in computer-readable forms, thus allowing for faster and more accurate scrutiny, and CPAs are legally responsible for their content.

## III. TAX REFORM AND INSTITUTIONAL DESIGN

What has actually happened? How was it possible to change tax institutions in Argentina and Mexico? Who was in charge of designing and implementing this significant policy change? What was the role of opposing groups and affected sectors? I will now analyze the previous questions. My argument is that it was possible to implement the new tax strategy successfully due to a structural economic crisis and the resulting transformation of societal preferences and strategies. In addition, the new tax strategy is very similar to the one supported by IFI and involved institutional change. The economic crisis of the 1980s dramatically changed people's preferences as macroeconomic stability became the major priority, even sacrificing (at least temporarily) historically solid values and ideas like social justice, economic national sovereignty and political independence. The concomitant crisis of the SCM impeded political and social actors associated with that matrix from articulating a sound and feasible alternative. This was due to the impossibility of maintaining the state as a mobilizing mechanism, and to the fact that atomized, individual strategies substituted for collective ones as the legitimacy of those actors associated with the SCM drastically faded.[16] In addition, due to the debt crisis, the fiscal crisis of the state, and the need to bargain with private lenders, the role of the IFI has increased notably. As the financial situation of these countries deteriorated continuously, the IFI had the chance to strongly influence domestic policy choices.[17]

In a nutshell, tax reform on the revenue side has generated a new institutional design: changing tax laws and enforcement mechanisms, enhancing revenue collection agencies, and improving administrative procedures.[18] Though it was by no means either a linear or a smooth process, in Argentina and Mexico successive tax reforms finally led to: (1) the broadening of the tax base, thus incorporating large sectors which had so far been able to avoid paying taxes due to the ineffective existing legislation; (2) the reduction of the nominal tax burden for income taxes, the elimination of ineffective taxes, and the overall simplification (in relative terms, as it is still claimed that forms and regulations can be further simplified) of administrative procedures for taxpayers; (3) the use of indirect taxation, namely the Value Added Tax (VAT), as the crucial policy tool; (4) the tightening of tax regulations governing, as well as improvement in the agencies in charge of collecting and overseeing taxation through the incorporation of up-to-date technology and new personnel, thus bringing about a substantial improvement of efficiency and capabilities in tax collection; (5) the incorporation into the tax process of key actors (professional associations, CPAs' guilds, and even the individual CPA) who had previously been involved in finding loopholes in the tax legislation, thereby furthering tax evasion. In both countries, these actors are now legally responsible for the tax returns filed by their clients, as they could forfeit their licenses (or even be incarcerated) if fraud is proved.

State actors have been the key players in reforming tax institutions. Other domestic actors and IFI have also been involved, but the role of technocrats (i.e., the so-called "economic teams"), tax agencies, and the executive power was nonetheless critical. In evaluating that role, it is important to consider at least two things. First, that the presidency has been substantially reinforced under Menem in Argentina and Salinas in Mexico. In turn, those stronger presidencies have facilitated the implementation of economic restructuring policies, particularly tax reform. Second, although it is apparent that the concentration of power in the executive has had detrimental consequences for democracy, it is also true that, in both countries, (1) democracy has a weak (Argentina) or almost nil (Mexico) tradition; and (2) strong executives have been a major attribute of both countries' political systems. Therefore, I think that the role of state, mainly executive actors, as well as the eventual fragility of democratic procedures should be interpreted as a continuity of prevailing features rather than as peculiarities of the emerging political system. What is new, though, is the kind of tax policy that is been implemented. Moreover, those state actors are now strengthening tax institutions, and that indeed means a crucial change.

Claiming that state capacity in Argentina and Mexico has increased is contradictory to the neoclassical as well as (neo) structural (and more or less radical) paradigms.[19] Both assert that state should be or is being weakened, and that markets should be or are in charge of allocating resources. However, due to tax reforms, in Argentina and Mexico the state has increased its extractive capacity and therefore its ability to obtain and distribute resources. In addition, by saying that state actors have been the key players in reforming tax institution, I'm questioning another generally accepted claim, i.e., that international actors, rather than domestic ones, are the protagonists of this game. Indeed, it could be argued that stabilization and structural reform packages, including tax reforms, have been an imposition of international financial agencies and creditors, and that domestic actors have lacked the capacity to decide how, when, and what to reform. Even though it is impossible to ignore the role of international actors, I would nonetheless argue that domestic actors, coalitions, and political processes (in other words, the political mechanism behind economic reforms) are prominent elements in this game. Let me now briefly analyze this mechanism.

As part of the policies of economic restructuring, a contingent coalition formed by incumbents, technocrats, private actors and representatives from IFI designed and implemented tax reforms. This coalition would eventually face internal confrontation on some particular issues. However, it would resist over time despite some internal splits and/or early, partial failures in the implementation of restructuring policies. Obviously, for a reforming coalition to succeed, no alternative or blocking coalition is to be formed. In other words, collective action problems (especially non-cooperative strategies as described by the prisoner dilemma literature) must be avoided. In this respect, it is crucial to have invigorated institutional tools to avoid such behaviors. For instance, the use of decrees, executive orders, or even the threat of using the veto power of the executive can discipline actors' behavior. Also, the core of the coalition ("the reformers") may eventually employ some informal tools to secure compliance among its members).[20]

The experience regarding tax policy in Argentina and Mexico has a paradoxical outcome. On the one hand, tax reform was a key part of the reform strategy. On the other hand, the new tax structure was also used as a tool to encourage support for economic reforms. That is particularly the case of those sectors that had supported nominally, though not really, most of the tax burden under the previous structure, i.e., high-income sectors, big local conglomerates, etc. Eventually, they could have been chosen as the focus of the new tax strategy through direct taxation. They were, but not to the fullest extent possible and only after indirect taxation was selected as the key tool of the new strategy. Moreover, by increasing the number of taxpayers and reducing the nominal burden, the reformers discouraged the development of opposite coalitions.

The experience of both countries suggests that in dealing with potential opponents, reforming coalitions can: (1) enlarge the tax base for both direct and indirect taxes; (2) expand the relative and absolute importance of the Value Added Tax;[21] and (3) compensate the losers of the new scheme with proper policies or policy outcomes (price stability, an overvalued rate of exchange, etc). Thus, even though private interests would eventually support or oppose particular policies (according to the actor's interests and relative political and economic resources), partial opposition would neither halt or jeopardize economic reforms. Finally, I argue that the particular dynamic of economic restructuring (i.e., its complexity, the thoroughness, and the lack of information about the actual consequences) helps frustrate successful alternative coalitions.[22]

## IV. CONCLUDING REMARKS

In this section, I want to stress one important attribute of reforming taxation in the way Argentina and Mexico did under Menem and Salinas, respectively. The new tax strategy works in a virtuous circle fashion, thus reversing the tradition of both countries in this regard. Tax agencies now have the technical and legal capacity to correctly administer the tax process. There is an obvious political commitment by the executive to support tax agencies and their leaders. Taxpayers now perceive the change in state's priorities and capabilities, consequently deterring non-compliance behaviors. Then, tax evasion has been substantially reduced. Moreover, by enlarging the tax base and actually identifying taxpayers, it is possible to further reduce tax evasion. The "black", informal economy has been cut down substantially, thus allowing previously unknown economic agents to become real or potential taxpayers. They can still evade taxes. But at least the Untouchables and fiscal terrorist have the chance to catch them now.

Also, although regulations must be simplified to further increase both transparency and efficacy, what has been so far accomplished is indeed significant and has had some important implications that are not generally recognized as such. Tax reforms have helped achieve macroeconomic stability. They have drastically changed the allocation of the tax burden by incorporating people that have been traditionally out of the system, specially middle-class sectors, professionals, self-employed, etc.[23] Moreover, taxation is nowadays an important electoral issue, and thus there is a novel concern about the allocation of resources by governments. There is not yet a "party of taxpayers" in Argentina and Mexico. But the new awareness about taxation may also prompt further changes in political parties' agendas.[24] In addition, upgrading state capabilities may eventually produce "spill-over" effects in the medium and long-terms, although the process of actual state reform has still a long way to go. However, there are already some positive symptoms in this regard.[25]

The experience of Argentina and Mexico shows that domestic actors, institutions, and processes (i.e., the political mechanisms which stem from the strategic interaction of actors), are still very important despite globalization and the emergence of powerful transnational actors and interests. Moreover, theories such as the world system that emphasize the role of international forces should still give enough importance to the role of domestic actors in shaping political outcomes. This is not to say that international constraints are not meaningful, but rather to stress the capacity of domestic actors to reshape institutions, therefore changing the balance of economic and political power within nation-states.

An important caveat, though, is the debate over whether or not these changes are permanent. Although institutional changes are indeed important and in both countries tax administration has in fact improved, it could be argued that in order for taxpayers to comply with the law, their payoffs have to be larger than the costs of compliance. In particular, macroeconomic and political conditions that allow actors to lengthen their time horizon must continue. For instance, speculations of unstable economic or political scenarios, recessions or, in a rather microeconomic setting, the rise of interest rates, could motivate a new surge of tax evasion.[26] Moreover, the electoral game can eventually influence taxpayers' choices. Thus, incumbents seeking reelection could find it difficult (i.e., electorally costly) to check non-compliance behaviors.[27]

All these caveats notwithstanding, the aforementioned changes in Argentina and Mexico are very important taking into consideration the previous experience of both countries regarding taxation. The story of tax reform is open-ended.[28] It is always logical, even imperative, to think of the possibility of a future tax reform. But in the case of Argentina and of Mexico, the argument and the protagonists of the story have changed. The Untouchables are now in town. They are here to stay.

TABLE I **ARGENTINA: SELECTED MACROECONOMIC DATA**

| | **1983** | **1984** | **1985** | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP | 3.7 | 1.8 | -6.6 | 7.3 | 2.3 | -1.9 | -6.2 | 0.1 | 8.9 | 8.7 |
| Investment (1) | -0.7 | -3.4 - | 17.8 | 15.2 | 14.0 | -2.0 | - 24.4 | -9.9 | 25.1 | 30.9 |
| Anual inflation (CPI) | 433.6 | 686.8 3 | 85.4 | 81.9 | 174.8 | 387.7 | 4,923.3 | 1,343.9 | 84.0 | 15.6 |
| Total Revenues (1) 12.1 | 12.2 | 16.8 | 15.6 | 14.7 | 13.1 | 14.0 | 13.4 | 15.4 | 17.5 | |
| Total Expenditures (1) | 22.3 | 18.1 | 20.4 | 19.5 | 20.8 | 17.8 | 16.9 | 15.3 | 17.4 | 19.1 |
| Deficit (1) | 10.1 | 5.7 | 3.1 | 3.2 | 5.7 | 4.0 | 2.7 | 1.4 | 1.1 | 0.3 |
| Tax burden (1) | 18.4 | 18.2 | 22.5 | 23.5 | 21.6 | 19.7 | 18.9 | 19.5 | - | - |
| Tax revenue as % of total revenue | 82.7 | 83.1 | 83.8 | 89.3 | 91.1 | 92.1 | 93.1 | 92.1 | 92.2 | 93.0 |
| No tax revenue as % of total revenue | 17.3 | 16.9 | 16.2 | 10.7 | 8.9 | 7.9 | 6.9 | 7.9 | 7.8 | 7.0 |
| Direct taxes (1) | 1.3 | 0.9 | 1.4 | 1.6 | 1.7 | 1.8 | 1.2 | 1.0 | 1.1 | 1.5 |
| The VAT (1) | 2.2 | 1.9 | 2.4 | 2.5 | 1.8 | 1.8 | 1.6 | 2.3 | 3.5 | 6.3 |

(1) As % of GDP

Source: IDB (1993), Progreso económico v social en América Latina, Washington, D.C.
Duran, V. and Gómez Sabaini, J. (1994)
Damill, M. and Frenkel, R. (1992)

TABLE II **MEXICO: SELECTED MACROECONOMIC DATA**

| | **1983** | **1984** | **1985** | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP | -4.2 | 3.6 | 2.6 | -3.7 | 1.6 | 1.4 | 2.9 | 4.3 | 3.5 | 2.6 |
| Investment (1) | 17.6 | 17.9 | 19.1 | 19.4 | 18.4 | 19.1 | . | . | . | . |
| Anual Inflation (CPI) | 80.8 | 59.2 | 63.7 | 105.7 | 159.2 | 51.7 | 19.7 | 30.0 | 19.6 | 10.5 |
| Total Revenues (1) 17.8 | 16.9 | 16.9 | 15.9 | 17.0 | 16.7 | 17.6 | 16.9 | 20.2 | 20.4 | |
| Total Expenditures (1) | 25.9 | 24.1 | 24.4 | 28.9 | 31.2 | 26.3 | 22.6 | 19.7 | 16.9 | 15.9 |
| Deficit (1) | 8.2 | 7.2 | 7.6 | 13.0 | 14.2 | 9.6 | 5.0 | 2.8 | -3.3 | -4.5 |
| Tax burden (1) | 20.1 | 19.1 | 19.1 | 17.5 | 17.8 | 21.5 | . | . | . | . |
| Tax revenue as % of total revenue | 57.4 | 61.0 | 60.5 | 70.4 | 62.9 | 72.2 | 67.5 | 67.2 | 57.5 | 58.9 |
| No tax revenue as % of total revenue | 42.6 | 39.0 | 39.5 | 29.6 | 37.1 | 27.8 | 32.5 | 32.8 | 42.5 | 41.1 |
| Direct taxes (1) | 4.2 | 4.2 | 4.1 | 4.3 | 3.9 | 4.8 | . | . | . | . |
| The VAT (1) | 2.8 | 2.7 | 2.8 | 2.7 | 2.8 | 3.0 | 3.0 | . | . | . |

(1) As % of GDP
Source: IDB (1993), Progreso económico y social en América Latina, Washington, D.C.
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## ENDNOTES

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2.However, in a later assessment on economic reforms (Willamson 1994), this author do recognize the importance of state regulation and the strengthening of state and civil society institutions for economic reestructuring to succeed.

3.As Acuna and Smith (1994) maintain, this approach is certainly much less homogeneous than the aforementioned one. The main common point among the authors is the rejection of neo-classical economic principles, principally regarding the idea that market mechanisms themselves would promote economic growth and development without state intervention and disregarding the overall international context. See, for instance, Borón (1991); Evans (1992); Fanelli (1990); O'Donnell (1992); and Sunkel (1993).

4.Haggard and Kaufman (1994) also recognize the strengthening of state capacity as a result of tax reform in the context of the instrumentation of neo-liberal economic policies.

5.To have a more thorough picture of this issue, considerations about the expenditure-side must also be included. However, for the purpose of this paper, I just focus on the revenue-side of fiscal reform. I stress particularly those institutional and policy changes that led to the sthrenghtening of state capacity in Argentina and Mexico, leaving aside other important problems such as the distributional and power consequences for different sectors. Still, I made some coments on this regard in endnote 23. For a further understanding of the politics of economic reform, see Haggard, S. and Kaufman (1992), and Smith (1994a, 1994b). On taxation and tax reform, see Bird (1992); Carciofi et al (1992); Durán and Gómez Sabaini (1994); Elizondo (1994, 1995); Gil Díaz (1993); Gillis (1989); and World Bank (1991).

6.Unions usually tried to get raises by renegotiating salaries after the official figure of inflation was released. However, it proved difficult for labor to get increases sufficient enough to counterbalance inflation. Also, the CPI included a number of goods and services that did not necessarily correspond to what an average household actually consumed.

7.The social status of inspectors was as low as that of any other plain state employee for whom ordinary people had no respect whatsoever. Working for the state was perceived as synonymous with laziness and incompetence. Though this was a prejudice, in fact the daily experience of people actually justified such a feeling: in order to make any simple transaction at a public (not just a tax) agency or state enterprise, interminable waits and lines were unavoidable. Complicated procedures, mounting regulations and often irrational instructions turned objectively uncomplicated issues into time-consuming endeavors.

8.For instance, employees would receive part of their salaries "in white", i.e., the minimum stipulated by the law, and part of them "in black", i.e., a complementary and non-taxable amount. Therefore contributions to social security would be calculated taking into consideration only the "white" part of the salary. Thus employees would also get more money than what it would be the case if the system were just "white". Notice that since the state also poorly administered the pension system, workers had no incentive whatsoever to give more money to the pension system. In any case, getting extra money on the spot was too great a temptation to preclude workers from disrupting the routine. In sum, the formal and informal economies were actually the two sides of the same issue: a micro-level reaction to both a macroeconomic unstable environment and poorly designed institutions.

9.The regular procedure consisted of finding out how much money the owner of the firm (since they were primarily family businesses), or the financial manager, was willing to pay. Then, the equation was inverted. CPAs had to do their job in such a way as (a) to satisfy owners' greed (as they were ultimately the bosses) and/or make things compatible with the firm's overall double system and financial constraints; and (b) to avoid calling the attention to the taxman by reporting tiny profits or figures inconsistent with previous years.

10.Before the 1980s some efforts to modernize the tax structure were realized in both Argentina and Mexico (as well as elsewhere in Latin America and other developing countries). Due to the encouragement of IFI and other international organizations (namely, the Organization of American States), since the 1960s numerous attempts to improve taxation have been done. Strongly influenced by the Alliance for Progress ideology, some domestic actors (technocrats, adherents of market-friendly policies in general) also supported those endeavors. Thus, the value added tax (VAT) was introduced before the last wave of fiscal reforms. However, as the core of the SCM was still very solid, achievements were only partial, ephemeral. Domestic actors supporting thorough fiscal reform were never strong enough to consistently implement those policies, although they did have some influence in other areas of economic policy making such as the Central Bank in Mexico. Furthermore, it was also difficult for international actors to effectively influence policy making regarding taxation. They were merely able to recommend policy change, but they lacked the capacity to watch, and eventually enforce, the proposed modifications.

11.The notion of crusaders is not just allegorical. Carlos Tacchi, the current Undersecretary of Public Revenue and the major actor involved in the new tax policy in Argentina, has very recently stated in a celebrated TV show (Tiempo Nuevo, April 12 1995) that "I owe God three very important things. I owe Him my own existence. He saved my son when he suffered a terrible accident riding a horse. And the third one: He allowed me to stay alive although I have cancer. For that reason, I promise God just one thing: I'm going to exterminate people who evade taxes. I'm going to fuck them all".

12. For a further discussion of the process of fiscal reform in Mexico, see Aspe Armella (1993); Bazdresch et al (1993); Lopez (1994); and Lustig (1992).

13.For instance, wages of inspectors are partially related to the fines they collect. So they have a clear material incentive to search for tax evasion, miscalculation, and other related problems as inspectors' income would increase if fraud is proved. However, some technicalities or minor mistakes may serve as an excuse to levy fines. Also, the complexity of the tax laws and other regulations may promote misunderstanding as both taxpayers, their CPAs and also inspectors could commit accidental mistakes. The only way to clear this problem is by further simplifying regulations. In both countries, there is a consensus in this regard.

14.Gil Diaz had drafted a new law that taxed firms' existing assets as a way to (a) increase revenue, but mainly (b) verify the genuine profits of firms, as tax returns stated that a great percentage of Mexicans firms were broke.

15. Defining a terrorist as "one who favors or uses terror-inspiring methods of governing (...)" ( The Concise Oxford Dictionary of Current English, London, Oxford University Press, 1959, p. 1316), and according to the Mexican tradition, it is actually quite understandable that business associations regarded Mr. Gil Diaz' methods

and goals as "terror-inspiring". He was certainly breaking an established, accepted code that had been in place for decades. More important, such an odd behavior had obvious material consequences for business.

16.The impact of the collapse of the SCM on labor and capital is however different. Indeed, the consequences of structural reforms within sectors are perhaps as important as between them. In particular, the main divide seems to be between tradeable and non-tradeable goods. Among the former, though, some sectors can resist better economic liberalization due to their capacity to obtain special protectionist policies, e.g., the auto industry. However, as a general statement, it could be argued that even though the emerging matrix seems to have less veto powers in comparative terms, capital does retain market power, particularly the capacity to determine the level of investment. Moreover, this is now more important than during the SCM era, as the public sector currently has a relatively passive role regarding investment.

17.As previously noted, tax reform is certainly not a new concern in the region. Moreover, international agencies had actively tried to influence fiscal policy well before the debt crisis. My argument, though, is that it is precisely this particular conjuncture (and the immense economic, political, and social consequences it brought about) that makes the story of taxation, fiscal reform, and involvement of IFI so different since 1982. I claim that the capacity of IFI to influence domestic economic policy has increased since 1982 due to crisis of the SCM and the myriad of societal and political changes which that crisis brought about. In sum, the change in domestic coalitions, societal preferences, state elites' strategies and capabilities, and the role of IFI (all of them closely related to the debt crisis and its aftermath), have blended together to allow the transformation of tax institutions in Argentina and Mexico.

18.Tax reforms should be understood as a part of an overall, and very ambitious, policy aimed at the elimination of direct and indirect subsidies which have grossly protected large sectors of the economy.

19.Is is worth noting that although some important contributions have already underscored the need to go beyond these simple notions (e.g., Smith et al 1994), however these paradigms still have a notable popularity.

20. I.e., to threaten local producers to further decrease trade barriers if prices increase, or local banks to tighten banking regulations if administrative costs are not reduced.

21.Distributive considerations have prevented reformers from increasing the relative importance of the VAT as much (and fast) as they really wanted. A strong political commitment was essential for such a decision, particularly in a competitive political system like the Argentine. But even in Mexico, where the outcome of elections was manipulated, distributional effects of extending the VAT were considered.

22.The preceding explanation challenges a series of partial potential (and generally accepted) explanations regarding particular aspects of economic restructuring. First, it is usually argued that uncertainty generates defensive strategies. However, my argument is that uncertainty, couple with positive initial results of restructuring policies, can help prevent defensive behaviors. Second, it is generally assumed that the reforming coalition is coherent and harmonious as its members share a common interests in pursuing economic restructuring. My argument, though, is that the internal dynamic of the reforming coalition is not as melodious as usually assumed. In particular, the so-called "technocrats" have a crucial role in creating (and reinventing) incentives for main actors to keep supporting economic restructuring. In this sense, fiscal and monetary policies can also be interpreted as tools for reformers to keep the coalition together. In sum, my argument is that the political engineering behind economic reforms is as important as the content itself of some policies, and their apparent coherence (or lack thereof) vis a vis the overall economic strategy.

23. Altough in this paper I am not consistently considering the distributional impact of the new tax system in both countries, I would nonetheless like to make some comments on this regard. First, tax reforms aimed at increasing collection to help stabilize the economy; then, as inflation was precisely prompted by the lack of tax revenue, an improved tax system was crucial to curb the toughest and most uneven of the existing levies, i.e., inflation. Second, although indirect taxes actually increased, the creation of strong and real enforcement mechanisms helped eliminate another source of unequality: the transfer of resources from consumers to firms' owners. In effect, under the previous system, final prices included the VAT, so in general consumers did not have the chance to evade it. However, firms (especially small and middle business) did have the possibility to decide whether or not to evade the VAT. In addition, the evasion of the VAT (and the "black" economy in general), created further inequalities within sectors by helping inefficient firms to compete. In turn, this situation (in a closed economy) discouraged investment, the incorporation of new technologies, etc. Finally, larger sectors of the economy, especially the so-called "liberal professions" (physicians, lawyers, CPAs, dentists, architects, etc.), but also famous artists and athletes who, in actuality, were previously excluded from the tax system, now pay taxes. Those sectors comprise the upper-middle class in both countries. Therefore, although indirect taxes (which are usually considered as "regressive") actually increased, it is worth stressing that the overall working of the new tax system, and both the context (inflationary environments) and the goal (stabilization) of the tax reforms, have a complex set of consequences which are ill-depicted by linear notion such as "progressive" or "regressive".

24.The recent economic crisis in Mexico also allows us to evaluate how much taxation has changed in both countries. Thus, in the context of ambitious stabilization policies, both governments have relied heavily on the VAT as a tool to increase revenue. Mexico increased the VAT by 50% (from 10% to 15%), while Argentina increased it by 11.7% (from 18% to 21%). Had tax reforms in both countries not occurred, it would have been unthinkable for both governments to even consider the VAT as an useful instrument. Also, the Chilean experience in the 1990s suggests that the state could assume a reformulated, but still vital role in social policy, and that taxation could become an appropriate tool not only for funding new social programs, but also for achieving macroeconomic stability (i.e., as a tool for applying restrictive fiscal policies if inflationary trends are detected). See Berensztein (1994).

25.Thus, in Mexico, migration agencies are learning from tax agencies' experience on how to improve administration, incorporate computer systems, train personnel, etc. In Argentina, the DGI is now in charge of the pension system, and collection and efficiency also improved quite a lot.

26.In fact, the recent Mexican crisis and the "Tequila effect" in Argentina seem to corroborate this speculation as tax collection has declined in nominal and real terms in both countries since December 20, 1994.

27.It is worth noting that in the medium and long run both countries may have to decrease the tax burden, mainly for business. Thus, the rigidity of the current monetary policy in Argentina may turn taxation into almost the only modifiable cost (at least in the short term) able to promote domestic activity and mainly exports. In Mexico, as Reyes Heroles (1991) has correctly argued, the current tax burden for business is very high if public goods obtained as a result of paying taxes are considered. As security, infrastructure, labor skills, etc. are very deficient, then firms must provide those goods and services by themselves, thus increasing transaction costs. Finally, the wave of market-oriented reforms undergone by numerous developing countries may also influence the level of taxation in

Argentina and Mexico. Thus, in an increasingly competitive international environment, as both countries badly need inflows of foreign investment, the tax burden could become a variable adjusted in order to encourage DFI.

28.As it is, in fact, the future of the new economic policy in both countries. Moreover, it is still to be seen whether the process of state reconstruction continues to include other areas or not.