# RESEARCH INSIGHTS

IDB

## Does Politics Trump the Ability of Having Successful Tax Reforms?

- **The probability of tax reform is higher during banking crises.**
- **Tax reform is unlikely to occur during election periods—even if the government is facing financing problems—so reforms that seek to raise taxes should be avoided at those times.**
- **The ideology of the president does not explain which taxes are reformed, or how they are changed, but the presence of an IMF program does.**

### CONTEXT

Given limited access to capital markets, governments in Latin America and the Caribbean frequently have to self-finance spending increases and the resolution of fiscal crises. When financing is needed, governments in the region traditionally look to increasing value-added tax (VAT), as it is easy to collect and implement. Although economic crises offer opportunities for reform, especially when the cost of continuing business as usual is very high, the political cost of undertaking reform close to an election may prevent countries from doing so.

### PROJECT

In order to investigate whether the government actually prioritizes politics or the economy, the tax reforms of 18 countries from the region during 1990-2004 were studied. Using an original fine-grained dataset of tax reforms, the study considers three taxes—and VAT, personal income tax (PIT) and corporate income tax (CIT). The study additionally considers when reforms were attempted and the extent to which they were implemented.

Key Concept

**VALUE-ADDED TAX**

A consumption tax that is calculated at each step in the chain of transactions until the final sale (so as not to have a cascading effect).

Key Concept

**PERSONAL INCOME TAX**

Direct and personal tax levied on an individual's income based on its amount and the individual's personal and family circumstances.

## RESULTS

Economic and political conditions have widely varying effects on different types of tax reform. During financial crises, the likelihood of an increase in VAT rises by 9 percent, and that of an increase in PIT by 6 percent. That is, countries with financial needs are more likely to increase taxes, especially VAT. CIT, however, is not significantly affected by such crises. Legislative elections have a much different impact on politicians' decisions. During election years, the probability of a VAT increase falls by 12 percent, while a VAT reduction becomes 4 percent less likely. CIT reform behaves much differently in election years, when it is 10 percent less likely to increase and 11 percent more likely to decrease. The interaction between banking crises and elections presents a third pattern. As legislative elections approach, a crisis becomes less likely to stimulate tax reform. In other words, even if a government is facing potential financial hardship, it will not raise taxes as elections approach.

The interaction between banking crises and other variables deserves particular attention. A banking crisis increases the likelihood of increasing the VAT only under an IMF program, confirming conjectures that presence of an IMF program favors an increase in VAT to deal with crises. Inversely, an increase in personal income becomes significantly more likely only in the absence of an IMF program. The interaction between the banking crisis variable and ideology was additionally studied to determine if different parties react differently to a banking crisis, and no statistically significant results were found.

Lastly, control variables including "number of previous reforms" and "time since last reform" tend to affect the probability of tax changes. The other significant variable is the impact on local reforms of the probability of a tax reform (VAT increase) in other countries, especially neighboring ones.

## POLICY IMPLICATIONS

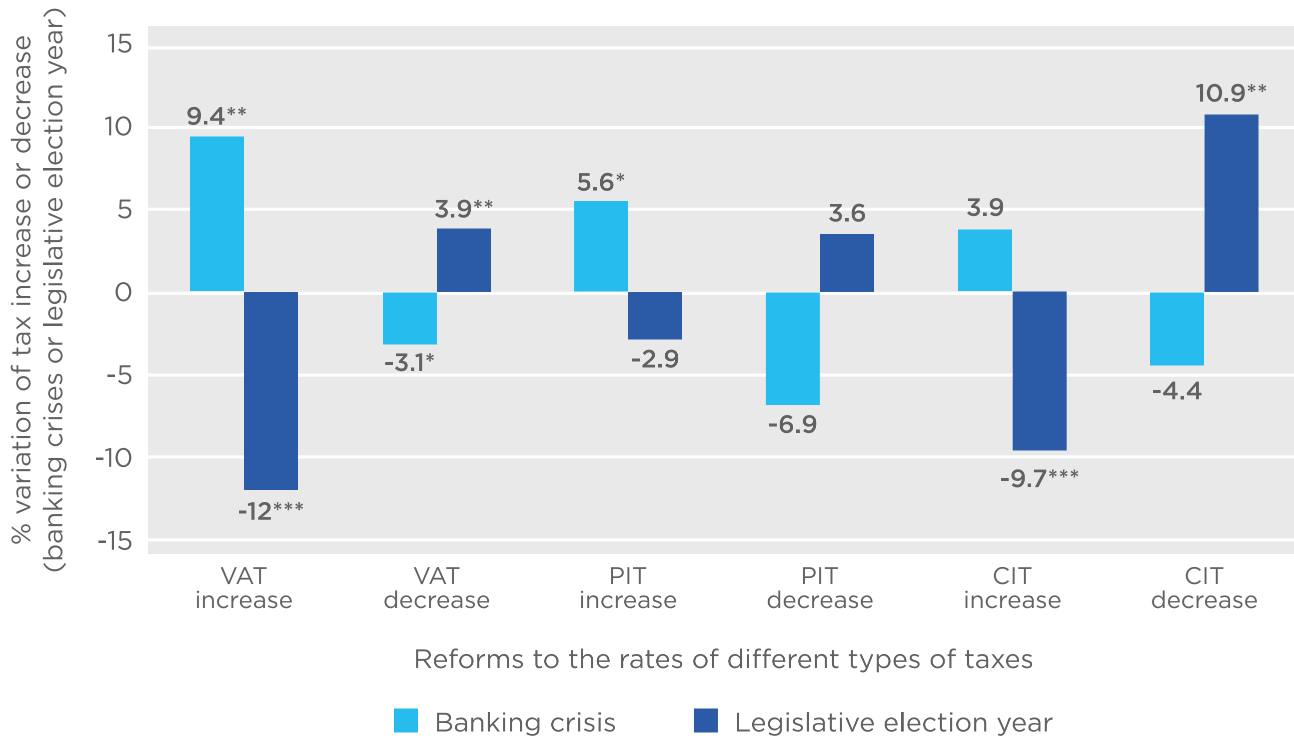
The results indicate that crisis and legislative elections matter for explaining the existence of tax reforms, as well as their direction and composition. Reforms that improve fiscal capacity—that is, those that lead to higher taxes—should be undertaken before legislative election years, as Latin American governments prioritize politics over the economy. Tax reforms attempted during or immediately before election periods or are very unlikely to be passed.

Moreover, tax reforms are not independent of past patterns of reforms. As such, when deciding on reforms today, it is important to internalize what types of reforms may incentivize or hinder. Additionally, reforms are also tied to how countries might be able to finance themselves with non-tax revenue sources, such as those coming from trade and natural resources. Given that the temptation to avoid politically costly but efficiency increasing tax reforms in favor of inefficient tariffs on trade is going to be high, politicians should tie their hands ex ante and make it very hard to affect trade flows that disincentivize investment and innovation.

## IDB RESEARCH ON TAX REFORMS

This document is part of a series of studies and initiatives that the IDB has supported to understand the political economy factors behind broad tax and fiscal reforms. Restoring and maintaining fiscal discipline is essential to ensuring sustainable growth in the region, and understanding the political environment facilitating it is critical to achieving that goal.

## Figure 1. Fiscal Reforms in Latin America and the Caribbean




*Note*: * p<0.10, ** p<0.05, *** p<0.01.

Key Concept

**CORPORATE INCOME TAXES**

Tax on the income of companies and other legal entities.

### FULL STUDY

Hallerberg, Mark, and Carlos Scartascini. 2017. "Explaining Changes in Tax Burdens in Latin America: Do Politics Trump Economics?" *European Journal of Political Economy* 48 (June): 162–79.

This study was also published as an IDB Working Paper.

### DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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