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Deflecting my burden, hindering redistribution: How elites influence tax legislation in Latin America

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WIDER Working Paper 2016/92

Deflecting my burden, hindering redistribution

How elites influence tax legislation in Latin America

Juan A. Bogliaccini¹ and Juan Pablo Luna²

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Abstract: This paper proposes to understand a singular but salient factor that enables the wealthy to deflect their tax burden downwards: elites' political leverage to shape legislation via their capacity to influence political actors and policy outcomes. The analysis sheds light on alternative mechanisms used by economic elites over time and space. Our analysis of the political economy of taxing upper-income groups in Chile and Uruguay reveals the importance of continuous political agency on the part of organized elite interest groups. Our results show how even centre-left parties competing on a redistributive programmatic platform confront and concede to the interests of wealthy elites, especially when sustained interaction between political leaders and economic elites becomes routinized in the long run.

Keywords: tax policy, Latin America, elites, tax avoidance, redistribution, case study

JEL classification: H24, H25, H26, B40

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1 Introduction

‘The President changes but the guests to La Moneda remain the same ones. Lagos had a strong discourse against corporatism, but at the end he fought labour corporatism, not business corporatism’ lamented a socialist member of parliament (MP) during a personal interview in Santiago de Chile in 2010.

‘We understand that our special situation, as professionals, merits a different tax category; let’s call it professional income tax. This tax, for equality purposes, should be similar to the tax for non-residents; let’s say a 10 per cent flat rate’, convincingly argued a lobbyist for a professional association to the House’s Tax Commission during the 2006 tax reform in Uruguay.¹

The relationship between wealthy elites and party officials in Latin America has been varied during the last quarter century and has been marked by a sharp transformation of both productive structures and social protection systems in the region. Sometimes it has been turbulent over the defence of special benefits, sometimes warm over the need to avoid policy stalemates. Yet, that changing relationship also explains why redistributive reforms have been scant in the region, vis-à-vis social policy innovations that do not directly entail redistribution, such as conditional cash transfers.

Diverse studies on the political economy of tax composition across middle-income developing regions find that Latin American economies tax upper-income groups much less than other economies in the developing world, such as those in East Asia and Eastern Europe (Di John 2006; Mahon 2011; Bird and Zolt 2015). Even in the developed world, for example the United States and Europe, evidence suggests that when inequality is reduced through government transfers to the poor, the wealthiest consistently deflect the tax burdens imposed on them (Winters 2011). The perils of taxing elites are closely related to the maintenance of durable inequalities—those that persist over the long run (Tilly 1998).

Which are the factors that allow the wealthiest to deflect their tax burden downwards? This paper proposes to understand a single but salient factor: elites’ political ability to shape legislation via their capacity to influence political actors. Our analysis sheds light on alternative mechanisms used by economic elites over time and space.

This paper seeks to explain why the challenge of taxing upper-income groups should be understood not only in terms of institutional tax capacity, institutional legacies, or the availability of revenues from external sources such as oil or minerals, but also as the result of continuous political agency on the part of organized elite interest groups. Even centre-left parties competing on a redistributive programmatic platform confront and concede to the interests of wealthy elites, especially when sustained interaction between political leaders and economic elites is routinized in the long run.

In advanced capitalist democracies, the wealthiest elites pursue their interests by lobbying in the policy arena, particularly in those areas that are both relevant to their economic position and obscure to the general public. Therefore, tax structure and reform processes constitute strong cases for theories about elites and class power. As tax policies are not zero-based, they allow a deconstruction of wealthy elites’ influence from an historical standpoint (Quinn and Shapiro 1991).

¹ Law 18083: Proceeding 52 of the Tax Commission, House of Representatives, 18 May 2006.

The aim of this paper is to provide a controlled comparison for Latin America, drawing on a historical and comparative analysis of tax reforms in two well-established democracies: Chile and Uruguay. The analysis of the political economy of the distributive conflict between wealthy elites and political parties is proposed as a comparison of two conflicts over policy reforms in each country. Understanding the role of political parties in these conflicts is particularly important as they link state and civil society. Political parties are able to provide the political support needed to legitimize state tax policies, as well as organize demands for social expenditure and tax breaks.

The proposed methodology draws evidence from extensive archival research on parliamentary proceedings and other documents for each of the four policy debates analysed, as well as on extensive research from press releases and interviews with key informants in both countries. Quantitative data on taxes and revenues will also be used to frame the comparison and provide background evidence in both cases.

The policy relevance of the paper is perhaps self-evident: power matters for explaining the excessive influence small groups have over much larger communities. Understanding elites' strategies to influence political actors in shaping legislation is pivotal to curbing their ability to divert the contributive burden towards less privileged groups. Weakening this capacity contributes decidedly to undermining durable inequalities and to allowing policy makers to move from bare social policy innovations to redistributive reforms. This is a particularly important issue in Latin America, where levels of inequality have proven resistant to the impacts of both sustained economic growth and sustained political democratization.

The paper is organized as follows. First, we present the evolution of tax schemes and elites' tax preferences. Second, we develop a controlled comparison of distributive conflicts in Chile and Uruguay in order to identify different mechanisms that led to regressive outcomes. Our analysis first reviews the evolution of the party systems in the two countries since the restoration of democratic rule to provide context for the comparison. Then, we describe the conflict over policy-making instances, and finally, we describe the relationship between political parties in each case and pivotal interest groups identified in our analysis, in particular the role of the rightist Independent Democratic Union (UDI) in Chile and the centre-left Frente Amplio (FA) in Uruguay.

2 The evolution of tax schemes in Latin America from a comparative lens

With the third wave of democracy in the 1990s, Latin American countries slowly engaged in successive tax reforms, focusing almost exclusively on consumption taxes, mostly the value-added tax (VAT). More recently, reforms were initiated for both personal income taxes (PIT) and corporate income taxes (CIT), with different emphases from country to country. The magnitude of reforms has been such that tax burdens have increased faster in Latin America than in any other part of the world during the last quarter century (Ter-Minassian 2012). However, these reforms have only sought redistributive goals as secondary-order objectives at best (Mahon 2012).

Latin America is a heterogeneous region in terms of democratic records and party system configurations (Kitschelt et al. 2010; Mainwaring and Scully 2010). Alongside differences in party systems, programmatic structure, and even stability, state capacity is also widely diverse in the region (Kurtz 2013; Soifer 2015). Regional differences in tax imposition and effectiveness are not independent from these characteristics. The expansion of VAT during the 1990s, for example, has been argued to improve the tax administrative capacity of the state in the region (Mahon 2004; Bird and Zolt 2015). State capacity, in turn, has been argued to affect effective tax

extraction, while low levels of extractive capacity feed back into low levels of state capacity (Centeno 2002; Kurtz 2013; Soifer 2013).

This mutually reinforcing relationship between state capacity and taxation has also been connected to the strengthening of representative political regimes. In analysing democratic paths in pre-modern Europe, for example, Boucoyannis (2015) finds that representation occurred first in strong states, where tax capacity was well-developed. This literature suggests that societal demands for accountability and better governance are more likely to emerge in response to tax regimes that are already effectively applied. However, the reverse has not been found to apply. According to Holland (2015), state weakness does not always explain weak enforcement. Instead, Latin America's elites have chosen not to enforce policies that could hurt the economic interests of subaltern social sectors, thus implementing 'covert' transfers that could also pay off electorally. Therefore, although taxation and state capacity are found to be important engines for democratic strengthening, the latter may occur in the absence of or without important improvements in the former.

In any case, the improvement of taxation in the region during the last quarter century has been led by steady increases in consumption taxes, which are known to be regressive but easily collected. It has only been during the last decade or so that income taxes have begun to play a more important role in tax schemes pursued in the region. The balance between the two main types of income taxes has also exhibited gradual variations from an initial pre-eminence of CITs towards the inclusion or expansion of PITs.

Although income taxes are more progressive than consumption taxes, a widely recognized problem with CITs is that the burden can be displaced towards consumers and workers (Bird and Zolt 2015). Similarly, PITs have become flatter during the last twenty-five years while their bases have widened (Lora 2012). Therefore, the described taxation paths in the region clearly suggest a combination of three elements that are functional to the elites' preferences for deflecting their tax burden. The first is simply the pre-eminence of consumption taxes as the main source of tax revenues. The second is the relative importance of CIT vis-à-vis PIT in tax schemes, mostly because these taxes can be more easily transferred down the ladder to consumers and workers. Finally, the flattening of PIT schemes has weakened their progressiveness.

In comparative terms, consumption taxes are the primary source of tax revenue in Latin America, while income taxes are the main source in North America (Bird and Zolt 2015). Furthermore, Bird and Zolt show that while CIT is the major source of revenue among income taxes in Latin America, PIT is the major source in North America. In comparing the United States and Europe, Alesina and Angeletos (2005) identify two fiscal equilibriums: on the one hand, Europe exhibits a propensity for big government with redistributive expenditures but less progressive taxes; on the other, the United States is characterized by small government with more progressive taxes but less redistribution. In Latin America, however, although there is reasonable variation in the size of governments, taxes tend to be regressive and also redistribution tends to be small (OECD 2008).

How do we understand elites' preferences in this context? A first set of widely discussed individual-level mechanisms is based on the extreme social distances in the region. For instance, inequality might shape the demand side of the representation equation by inducing a series of psychological effects at the individual level. Accordingly, high inequality might contribute to consolidating cognitive biases that could be consequential for political preference formation (see Shapiro 2002). 'Empathy' and 'physical distance' gulfs might emerge among individuals living immersed in different and segregated socioeconomic settings (Shapiro 2002). Those cognitive

gulfs distort the translation of the effects of inequality into political preferences across segregated settings; for instance, by making differences among localities or social groups invisible (and therefore, inconsequential for political action).

Framing effects are also relevant to understanding elite behaviour. These effects contribute to the emergence of distinct focuses of attention across social settings and groups, whose preference formation is primed, once again, in a socially segmented fashion. Overall, those processes make it more difficult for parties to engage in distributive preference formation and mobilization across social groups. This is the focus of another series of works (see particularly Reis 2011). Such works illustrate how elite preferences in high-inequality contexts and even in the presence of increasing security concerns continue to be strongly regressive. The latter defies O'Donnell's (1996) hypothesis regarding the possibility of a new redistributive pact to alleviate poverty emerging in Latin America under increasing criminality threats to elites. Indeed, evidence on the recent success of the Colombian security tax clearly suggests that the levy on Colombian elites was only viable due to the government's earmarking strategy (Rodríguez 2011; Flores-Macías 2015).

Elites' political action in the region reflects a strong preference for non-redistributive taxes, in particular VAT, and a strong opposition to income taxes and property taxes. This is true even for countries that are most similar to advanced democracies with respect to political variables such as democratic record, state capacity, or party system stability. Chile and Uruguay, for example, conform to evidence available for the United States and Europe, which shows that when facing redistributive threats the wealthiest consistently deflect the tax burdens imposed on them (Bartels 2009; Gilens 2012; Winters 2011; see Fairfield 2010, 2015 for Latin America).

Finally, political clientelism can also be seen as a mechanism that contributes to the electoral demobilization of subordinated sectors on the basis of different sets of side payments. While eventually sizable and massively disbursed, clientelistic side payments also help elite sectors to deflect their tax burden. Segmented party-linkage strategies that partially incorporate non-programmatic linkages (i.e. clientelistic, personalistic, etc.) between political candidates and poor voters, while incorporating programmatic linkages between those same candidates and elite voters, are particularly detrimental for progressive redistribution (Luna 2014).

The comparative analysis that follows illustrates how Chile and Uruguay also present an enduring feature of conflict over distribution: the struggle between organized actors to build enduring distributional coalitions with political parties. The comparison shows how elites manage to consistently perforate redistributive initiatives. In Chile a redistributive coalition exists without a clear demand from society or organized sectors—at least until the 2006 student protests;² in Uruguay there is a redistributive coalition and also strong redistributive demands from society. While in Chile the lobby of organized business has been particularly important in undermining redistributive initiatives, high-income professional associations have played that role in Uruguay.

As two of the most advanced countries in Latin America, Chile and Uruguay promise to reveal how the interaction between democracy and inequality can frustrate distributive reforms via elite protection strategies. Both countries have high institutional capacity for collecting taxes and, although Chile has copper as a prime source of income, their states and state officials are among the least prone in the region to engage in and accommodate rent-seeking and corruption. While

² These protests over several education-related issues, commonly referred to as 'the penguins march', were the largest student demonstration of the last three decades in Chile.

Chile is among the most unequal countries in the region and Uruguay is less so, elites in both countries have been successful in reducing their tax burden relative to the middle classes.

3 The evolution of party systems and their societal roots³

We will argue that the FA in Uruguay and the UDI in Chile were, for different reasons, pivotal partisan actors in shaping tax reform efforts. Before analysing the relevant policy-making processes and both parties in greater depth, with a special focus on their linkages to relevant interests groups, let us briefly explore the context for the evolution of each party system during the last quarter century.

The Chilean party system has recently been marked by three systemic trends: the weakening of parties as institutions, their declining social legitimacy, and the rise of independent-like candidacies within established parties. Party leaders of all parties customarily refer to the social devaluation of parties. Such devaluation is two-fold. Parties have weakened as collective institutions within which like-minded individual leaderships pool resources and cooperate. As collectively available resources have diminished, leaders increasingly seek to craft an independent image divided from the party's fortunes. In this context, partisan structures have grown hollow and have come to be perceived as dominated by closed 'oligarchic' cliques with power (especially nominating power when incumbents do not run for re-election), but with decreasing legitimacy and ascendance over the rank and file.

Whereas before 1973 partisan networks worked out encompassing brokerage structures linking centre and periphery and were functional in reproducing organic partisan ties and popular loyalties, today those networks have atomized. This disintegration has hindered parties' institutional capacity. Instead, the emerging configuration feeds into increasing levels of cynicism, internal conflict, and anti-party attitudes at different levels. At the same time, individual candidates' increasing reliance on private campaign contributions by business groups has arguably extended the capacity of business to lobby on the congressional floor in order to shape legislation. The inbreeding between business sectors and the political system as a whole was clearly exposed by a series of corruption scandals that broke out during 2015; figures linked to all relevant political parties in the system were incriminated in irregular campaign financing, tax fraud, trafficking of influence, and the trafficking of qualified information.⁴

In Uruguay, the party system has changed less dramatically. Nonetheless, there are some parallels with the Chilean situation: the decline of brokerage networks, and the progressive development of more oligarchic party structures. National party leaders have been increasingly unable to deliver the goods needed to sustain their local structures. Local leaderships have instead become hegemonic. In this competitive context, partisan brokers from outside the factions of locally hegemonic leaders find themselves lacking resources to operate. They then either shut down their organizations (at least in between elections) or cross party lines to strike deals with local authorities willing to give them resources to keep their organizations alive. Both of these responses hamper articulation among traditional parties' widely dispersed territorial organizations.

³ This section partially reproduces text included in Luna (2014, chapters 3–6).

⁴ The most relevant cases have been the PENTA case, the Caval case, and the SQM case.

At the same time, facing increasing budget constraints and growing pressure from local brokers for material help, national leaders have favoured ‘relatively cheap’ local leaders with access to their own resources that are not dependent on national leaders’ brokerage or financial resources. Nonetheless, parties as collective institutions and social identities, remain stronger in Uruguay than in Chile. This outcome is consistent with the pursuit of party-centred (instead of candidate-centred) linkages.

Uruguay’s traditional parties historically had partisan offers characterized by high levels of internal diversity, supplied through internal competition among multiple party factions. They have gone through a process that has restricted that internal diversity, while deterring wider participatory processes within parties. Despite facing ever-increasing demands, their traditional means of providing for the people on the basis of centralized brokerage networks have been drastically reduced. Traditional parties began to lack the capacity to sustain some linkage types that were central to the pursuit of their historically segmented strategies, and began to show low levels of segmentation and declining levels of harmonization. Relying on party-centred appeals alone as the competitive context changed, those parties have found themselves with virtually no credible appeals to make; neither a programmatic option compelling to the popular sectors (i.e. an alternative to unpopular liberalization measures), nor access to goods that could be centrally distributed to appeal to voters.

Finally, but key to our argument, the economic crisis of 2001–02 also contributed to the deterioration of the historical linkages between business elites (particularly in the rural and industrial sectors) and the centre-right Blanco and Colorado parties. Massive and sustained economic growth during the past decade under a FA government has also contributed to the weakening of those historical linkages. Yet, as we will argue, professional sectors tied to Frente Amplio were the pivotal players blocking progressive reform in Uruguay, while business interests played a central role in Chile.

4 Elites’ lobbying strategies over tax imposition⁵

4.1 The club of professionals in Uruguay

For the case of Uruguay, we study two conflicts linked to a comprehensive tax reform process. These conflicts illustrate how organized actors attempt to build enduring distributional coalitions with political parties. The ambitious reform carried out in 2006 by the recently inaugurated centre-left government offers the opportunity to study two parallel conflicts: a conflict between business corporations and the government regarding CIT and another between groups of professionals and the government regarding PTT.

The conflict between business and the government over tax imposition unfolded over two separate issues: the proposal to harmonize employers’ social security contributions to a 7.5 per cent flat rate, and the proposal to increase corporate income taxes. Business has not been a strong political player in Uruguay since the collapse of the Import Substitution Industrialization model (ISI), mostly because of internal divisions born out of the defence of special benefits at the sector level.

Meanwhile, the conflict between professional groups and the government occurred over the implementation of a PTT scheme. Unlike the business sector, professionals in Uruguay had been

⁵ This section draws on relevant sections of Bogliaccini (2012), Chapter 4.

very successful in defending special benefits such as not having their incomes taxed or maintaining their social security pay-as-you-go scheme rather than entering the quasi-universal scheme after a comprehensive reform in 1995 (Filgueira and Moraes 2001).

The 2006 reform was the fulfilment of the FA electoral campaign's central issue: to substitute the payroll tax with a comprehensive income tax and to simplify the tax structure, eliminating 15 categories of taxes.⁶ During the parliamentary debate over the initiative, which was unexpectedly long given that the government had a majority in Congress, 78 business, labour, and professional groups lobbied separately (in 65 meetings with Hacienda Commission members in both the House and Senate), as shown in Table 1, to maintain special benefits or exemptions (Bogliaccini 2012).

Table 1: Uruguay, lobby strategies during 2006 tax reform

Social sector	Organizations	Delegations	Lobby
Business	42	34	Avoid increases in employer's contribution to social security and corporate tax
Workers	5	5	Avoid publicly funded private social security funds taxing or elimination
Professionals & other white-collar workers	15	14	Income tax exemptions and special benefits
Cooperatives	5	4	Corporate tax exemption
Retirees	11	8	Avoid being taxed by the income tax
Total	78	65	

Source: Based on Bogliaccini (2012).

Organized business did not oppose the initiative as such, but opposed tax increases on the business sector. However, as the tax structure was full of special benefits for different groups, business did not engage in inter-sectoral coordination. This lack of internal coordination debilitated the business lobby both with the governing FA and opposition parties. As a result, the reform succeeded in unifying the employers' contribution to social security at a 7.5 per cent flat rate.

We believe there is confusion between the equality and egalitarianism concepts [...]. In the case of the manufacturing industry, the reality is totally different to the one of trade sector or those that sell non-tradable goods or services. Therefore, this situation [making employer's contributions to social security the same in all sectors at 7.5 per cent] is harmful for the industrial sector because it is not fair to tax similar sectors with different realities. (Mr Villamil, Uruguayan Industrial Chamber General Manager, in the House's Hacienda Commission; see House Hacienda Commission (2006a))

The most important obstacle to tax reform came from the effort by different FA sectors to defend the interests of professional groups (mostly belonging to the upper two income quintiles). The lobbying strategy of professional groups centred on being excluded from the proposed PIT scheme, signalling that they would be open to discuss a particular tax for them (*La Republica*

⁶ The reform was approved in 2008 (Law 18083).

2006). During their visit to the House Commission, some professional groups even proposed a ‘professional rent tax’ (House Commission Proceedings 52 and 72; see House Hacienda Commission (2006b, 2006c)). However, these initiatives failed to persuade the government’s top officials, as made evident by a public intervention made by the Economy Undersecretary at the time:

The ideal would be to control one by one each professional, but the cost-benefit relationship of this implies an excessive administrative effort in order to fight the ‘kings of the tax subterfuges’. (Mr Bergara, Economy Undersecretary in the Conference ‘The year of the tax reform’ organized by KPMG, *El Observador*, 5 April 2006)

As a consequence of this first drawback, professionals changed their strategy down the road. As the project established that professionals with large earnings would be able to switch from a PIT scheme to a more convenient CIT scheme, flattering the curve at the top end of the distribution, the lobby concentrated on discussing this specific tax rate cut-off point (Senate Hacienda Commission, Proceeding 1404; see Senate Hacienda Commission (2007)). This entailed a clear opportunity for the wealthiest to deflect their tax burden. While professionals under a CIT scheme would be taxed at a rate of a fixed 12 per cent—formally 25 per cent of 48 per cent of gross earnings—those under the PIT scheme would have a marginal income tax rate of 30 per cent (over 70 per cent of earnings). This lobby was successful, the wealthiest being able to secure the scenario in which their taxes would be lowest.

However, in 2014 the second FA administration reduced the benefit of switching from PIT to CIT by imposing two new marginal rates for corporate taxes paid by this group, at 15 per cent and 18 per cent. This measure, while making more restrictive the choices for the elite, still allows the rich to reduce their tax burden.⁷

Professionals also were able to gain for themselves a cap on their contributions to the national health system enacted in 2007 (law 18211). While professionals had to secure health insurance entirely out-of-pocket before the reform, the new scheme obliged them to contribute to the health system with a fixed percentage of their incomes as declared yearly to the national revenue office. However, professionals successfully lobbied to cap their contribution. This situation backfired for the government, which was obliged to extend the benefit to every dependent worker, once again benefiting disproportionately those in the upper two quintiles. As an illustration, in 2014, the wealthiest 6 per cent of dependent workers (excluding self-employed professionals) were reimbursed a total amount of around US\$67 million (El País 2015).⁸ The amount reimbursed was equivalent, in 2015, to about 2.5 percentage points of VAT revenues.

To sum up, the analysis shows how, in order to understand the weakening of tax reforms in Uruguay, we need to delve deeper into the politics of factional conflict within Frente Amplio, to which we turn after proceeding with a parallel analysis of the political economy of tax reform in Chile.

⁷ Decree 150/007, article 168.

⁸ This calculation excludes the burden deflected by professionals not working as dependents because the law allows them to stop payments once they reach the cap.

4.2 The power of a well-connected business in Chile

In Chile, the defence of a favourable tax structure freed of particular entitlements, inherited from the military government, set the conflict between the wealthiest elites and a government attempting to expand social protection (Boylan 1996; Weyland 1997; Fairfield 2010). As in Uruguay, we will examine two tax conflicts. The first relates to the 2001 reform attempt by the centre-left Concertación coalition government, which sought to increase the extremely low marginal corporate tax in exchange for a reduction of the VAT. This case is significant because a well-organized business class succeeded in controlling the negotiations and in softening the reform proposal by directly engaging in negotiations with the president before the draft proposal was sent to Congress. The private negotiation between the executive and business was pivotal in avoiding a public debate on the reform.

The second conflict we analyse unfolded in 2004, when the centre-left government sought to establish a universal health system that involved unfavourable changes for business interests participating in the systems' financing scheme. Unlike the first reform proposed in Chile, this conflict led to open public confrontation among several interest groups (e.g. consumers of the private system, health insurance providers, and the medical unions). The most interesting aspect of this conflict is how the government was able to negotiate the reform in Congress, an institutional arena in which interest groups should lobby at a higher cost. Yet, even in such a context, elite interest groups were successful in transferring the cost of the new system to an increase in (regressive) consumption taxes.⁹

The 2001 tax reform was a second important attempt by the Concertación to modify the tax structure.¹⁰ The initiative was oriented towards modification of the tax structure along the lines of a previous reform during the first democratic administration (1990–94). Unlike before, however, the Concertación had a majority in both Houses and therefore agreements with centre-right parties were not necessary, provided internal agreements were reached within the governing coalition.

The 2001 proposal included increases in the corporate marginal tax rate from 15 to 18 per cent, with a reduction in the income tax rate from 45 to 35 per cent. The tax reform, presented as fiscally neutral by the government, aimed to reduce the distortions in the tax system. The significant distance between the existing 45 per cent marginal income tax rate and the 15 per cent corporate rate encouraged individuals to mask their personal income as business income on the top categories of personal income tax, thereby giving a major tax break to business owners (Mr. Eyzaguirre, Economy Minister to the House. Hacienda Commission First Proceeding to the House, History of the Law 19753, page 21).

Organized business supported the drop in income tax rates but opposed the corporate tax increase from the beginning (*El Mercurio* 2001a). Business strategy was based on aggressive lobbying against an increase in corporate tax, and it thereby reduced the government's ability to lower the marginal income tax rate. Lobbying was carried out at the top of the government structure. Business leaders met directly with President Lagos (CPC President, Mr. Ariztia) and Vice-President Insulza (CNC President, Mr. Lihn).

⁹ The Chilean tax reform of 2014 followed a different path to Uruguay's 2007 reform. For that reason, we instead analyse the distributive conflict that developed in 2004 around the Auge reform.

¹⁰ Law 19753.

The rightist Independent Democratic Union (UDI) remained unwilling to vote for any increase in the corporate tax (*El Mercurio* 2001c), while the National Renewal (RN) was only willing to support a 1 per cent increase in the marginal corporate tax. In the next section we will describe the importance of the relationship between organized business and the UDI in forcing the government, even with a majority in Congress, to concede to a compromise on corporate tax increases.

We will keep the promise of advancing this reform only if it has a generalized consensus that avoids transforming this in a new economic dispute. (Mr. García, Presidency General Secretary, *El Mercurio* (2001c))

The final draft sent to Congress after these meetings was already less ambitious than the original one. It included a drop in the upper boundary of the income tax's top category from 35 to 32 per cent, and two new categories on top of this one, one taxed at 37 per cent and the other at 40 per cent (instead of the initially proposed 35 per cent), alongside an increase in marginal corporate tax from 15 to 17 per cent. It took only one month to approve the bill once in Congress. The increase in the corporate marginal tax rate was gradual: 1 percentage point in 2002 and an extra half-point each of the following two years (*El Mercurio* 2001b). A Concertación Senator expressed his frustration about the reform:

Chile has high inequality and we tried to propose tax reforms to moderate inequality. We still need to eliminate tax exemptions for big capital. Corporate tax is too low; we need to increase it from 17 to at least 22 or 23 per cent (PPD Senator, personal interview 2010).

CIT only increased to 20 per cent by 2010 after a devastating earthquake. In 2014, the governing Concertación approved an ambitious tax reform that included a gradual increase in the marginal corporate tax to 27 per cent in 2017, which was already lower than the 35 per cent envisioned in the original draft but similar to the average CIT in OECD countries. However, just a year later, Chilean centre-right opposition is lobbying side by side with business to take the marginal corporate tax to 25 per cent instead of 27 per cent. Although this debate is far from being settled, it once again illustrates how wealthy elites attempt to deflect their tax burden.

The second conflict unfolded in 2004 around the Concertación government's draft for a universal healthcare system (AUGE—Universal Access with Explicit Guarantees), in particular with respect to the system's financing mechanisms (Dávila 2005).¹¹ Unlike the previous conflict, this one led to open public confrontation among several interest groups (e.g. consumers of the private system, health insurance providers, and the medical unions). The most important aspect of this conflict is how the government was able to negotiate the reform in Congress, an institutional arena in which interests groups should be expected to lobby at a higher cost. Yet, even in such a context, elite interest groups were successful in transferring the cost of the new system to an increase in consumption taxes.¹² In this regard, in the congressional negotiation, opposition parties (allied with the private provider segment of the health market) were able to block an initiative that incorporated progressive transfers between contributions to the private and the public system. While that was a crucial element in guaranteeing the segmentation of both markets, it also allowed private providers (ISAPRES) to participate in AUGE services.

¹¹ Law 19966.

¹² In 2003, the VAT increased from 18 to 19 per cent to finance the Auge Plan, which was projected to require about .25 per cent of that tax for its implementation and functioning.

This case illustrates how the government was able on the one hand to avoid stalemate by introducing a reform ‘idea’ with some basic principles (i.e. a system that would universally cover an explicit list of illnesses) to be debated later in Congress, and by bypassing the Ministry of Health (thus dislocating traditional lobbying structures in the health system). Yet on the other hand it illustrates how, on the congressional floor, opposition parties and their allied interest groups were able to protect their interests and even gain more leverage in the new system.

The analysis shows how pivotal it is to understand the linkage between political parties and interest groups (especially business interests). Whereas those linkages are transversal in the system, they were key in explaining the behaviour of opposition parties (especially the UDI). That party, acting in a highly constraining institutional environment that favoured the status quo, was key in shaping observed distributive outcomes in this case. The next section delves deeper into the analysis of party–business linkages in Chile, as well as a detailed account on the UDI.

5 Party-interest group linkages¹³

5.1 The UDI in Chile

We tell our friends: ‘to represent you, we should get more votes in the popular sectors, not at the elite level where we cannot get more’. So we ask them for their financial support, but we also ask them to abstain from showing up with us; in the snapshot, we will always be with the poor, not with them. (...) It was hard for them to understand that we needed to appeal to the poor, but that’s where there are more votes to grasp. (Anonymous UDI national leader, personal interview, 2008).

Organizationally, the UDI originated as a homogenous, hierarchically organized movement of urban university students (*Gremialistas*), advocating reduced state involvement in society, except to promote moral and religious values (Joignant and Navia 2003). When the military came to power in 1973, *Gremialistas* became close collaborators of his authoritarian regime. State retrenchment in the wake of neoliberal reforms created affinities between the ‘Chicago Boys’ collaborating with the military and the *Gremialistas*, which came to represent the dictatorship’s economic and political legacy, thus commanding special allegiance from business interests and conservative social groups (Huneus 2001).

Through their involvement in the authoritarian government, the *Gremialistas* worked to construct a new party that could become the main political force in the country in the event of re-democratization. The fulfilment of this task, facilitated by institutional incentives in the 1980 Constitution and the (binominal) electoral law, would be a crucial safeguard for the military’s legacy after the inevitable (though ideally limited) process of democratization that the UDI’s leaders were anticipating.¹⁴

While all other relevant parties in the system (with the exception of the Party for Democracy—PPD) lost electoral support in lower-chamber elections from 1989 to 2001, the UDI’s support base doubled over the same period. Though declining slightly from its 2001 peak, the UDI

¹³ This section draws on relevant sections of Luna (2014), Chapter 6.

¹⁴ For a more thorough and systematic account of the historical development of the party and its doctrine see Pollack (1999); Huneus (2000a); Huneus (2000b); Huneus (2001); Morales and Burgueño (2001); Joignant and Navia (2003); San Francisco (2003).

remained the strongest party in the lower chamber in 2005 and 2009. At the municipal level, the UDI also experienced steady electoral gains, reaching almost 20 per cent nationwide in 2004 and again in 2008. The UDI's electoral performance has been most notably positive at the two extremes of the social ladder, maintaining a solid base in its core constituency (the upper segments of Chilean society) while making steady inroads into a non-core electoral base (the popular sectors).

What is of interest in the context of this paper is the UDI's link to its core constituency. The link between the party, business elites, and conservative sectors translates into a solid vote based on strong partisan and programmatic identifications frequently reinforced through media addresses by MPs and national candidates. The UDI's linkage to wealthy segments of Chilean society is also based on interest representation in Congress, which party strategists see as a fundamental selling point for business elites who not only support the party electorally but also contribute resources for funding partisan activities elsewhere.

The district [23] is a very peculiar one [the district where wealthier individuals live in Santiago de Chile]. It is likely the one in the country that is most heavily influenced by public opinion. That is, 90 per cent of the people who live there are not expecting me to solve a specific problem for them. Nor are they expecting me to visit their home, give them something, or solve a social problem for them. What they expect is that I represent their opinions in the media. And that in Congress I vote like they would, if they were in my seat. (Julio Dittborn, UDI Congress member, personal interview, 2003)

Why would business elites contribute disproportionately to the UDI, particularly back when the party commanded a very small congressional contingent? According to a top party leader, 'our leaders convinced business elites that the party would be able to protect the market-oriented model introduced under Pinochet, aided by the special majority requirements that Jaime [Guzmán] included in the 1980 Constitution' (Anonymous UDI national officer, personal interview, 2008).

An analysis of voting patterns on the congressional floor clearly identifies the UDI as the party that more consistently voted to defend the market-oriented reforms introduced by Pinochet. In the 2006–08 period, for instance, the rightist coalition of the Alianza por Chile (UDI and RN) displayed very high levels of internal discipline in almost all congressional votes (93 per cent). However, in the remaining 7 per cent of the votes, (approximately 90 bills), the UDI is clearly the one party on the right to have voted more consistently to defend business interests (see Luna 2010).

Luna (2014: 210–12) shows how UDI, much more consistently than the RN, systematically opposed legislative packages that would potentially hurt business interests or redistribute resources to lower social strata, such as minimum wage increases, tighter market and labour regulation, state education subsidies, and tax and pension system reforms.

Campaign spending evidence suggests that the relationship between the party and business interests has been mutually beneficial. Based on self-reported campaign spending averages for all lower-chamber candidates competing in 2005 races, under each party's banner, Luna (2014)

shows how the UDI spent an average of US\$90,000 per campaign, second to none and overspending its Alianza partner (RN) by an average of US\$30,000 per campaign.¹⁵

In the case of municipal elections, according to a campaign spending report available for 2004, the UDI spent the most, outspending its closest rival (RN) by more than 100 per cent.¹⁶ Furthermore, whereas reserved donations accounted for approximately 40 per cent of the Concertación parties' campaign expenditures, they accounted for more than 60 per cent of the UDI's.¹⁷ Available evidence for the 2008 municipal elections highlights once again the exceptionally heavy role of private donations in the financing of the UDI. In short, the UDI has developed a financial edge over its competitors by extracting financial resources from its core constituency. Those resources are then strategically invested in crafting different types of linkages in poor communities, where the party has developed a non-core electoral base (see Luna 2014). More internally coherent and disciplined than others in Chile, the UDI established itself as the most successful party within its national system, a feat also accomplished by the FA in Uruguay, albeit by different means.

4.2 The Frente Amplio in Uruguay

This campaign [2004] is one of the easiest ones that we have had [...]. You just need to step on the corner and ask: 'Who is responsible for this mess?' Then you start distributing printed ballots in the street. [...] Today, there is the hope of the poor, of business people, and of the rural sector. (Eleuterio Fernández Huidobro, interviewed in *Página 12*, 13 September 2004. Tagliaferro (2004))

In 2005, the Uruguayan left, led by the FA, came into power, breaking 175 years of traditional party electoral dominance. The FA's presidential triumph was coupled with the attainment, for the first time since 1966, of an absolute congressional majority, marking a political watershed in the country's history.

The FA's electoral success resulted from the pursuit of a complex transition to a professional-electoral, increasingly catch-all party (Luna 2007). Such transition, from a predominantly urban, labour-based, centre-left mass party took place in an opportunity structure shaped by the dismantling of Uruguay's state-centric sociopolitical matrix (Cavarozzi et al. 2003; Yaffé 2005). In a context also marked by economic decay, the traditional Blanco and Colorado parties became less able to retain their historical electoral constituencies. Meanwhile, FA successfully moderated its platform while still consistently opposing market reform. The party thereby mobilized its core constituency through programmatic appeals, defending the state-centric model and its stakeholders' social interests. This programmatic stance allowed the party to maintain its core constituency in middle class segments and organized labour. However, those white-collar segments were pivotal in later blocking—at least partially—attempts at progressive tax reform by the FA government.

When I returned from exile in 1984, we still had powerful industries in the country, as well as very well articulated unions. Today we see them disappearing, the leather, the metallurgical, the textile, are all dead. [...] It is obvious that these trends reflect the economic model that has been applied in Uruguay. The PIT-

¹⁵ See also, Huneus et al. (2007), Diaz Rioseco et al. (2006).

¹⁶ Instituto Interamericano de Derechos Humanos (2005: 56).

¹⁷ Instituto Interamericano de Derechos Humanos (2005: 58).

CNT [the central labour confederation] still breathes and has been maintained due to the power of the banking union and those of the public administration [state employees]. But those unions are not typical unions; they are not working class unions. (Ernesto Agazzi, FA Congress member, personal interview, 2003)

The FA was created in 1971 as a popular front that merged communists, socialists, Christian democrats, leftist independents, and factions splitting from both the Colorado and Blanco parties (Luna 2007). Today the FA is one of Latin America's most institutionalized leftist parties. From 1990 onwards, the FA was in charge of the municipal government of Uruguay's capital city, Montevideo, which is home to approximately half the electorate. FA's arrival into (municipal) government was also pivotal in contributing new electoral bases for building the 2004 presidential win (Luna 2007). In that regard, FA's experience at the municipal government also promoted moderation, proved FA's capacity to go govern, and helped the FA to build a political machine that was able to penetrate electoral strongholds of the traditional parties in the city's urban periphery.

As a result of this trajectory, the FA currently has a double support base in Uruguayan society, comprised of its original constituency (urban middle class sectors with ties to the old ISI model) and a new constituency (voters in the informal labour market, the poor, and rural inhabitants). This new constituency gradually became disenchanted with the traditional party elite as a result of economic hardship and the decline of traditional clientelism. The FA was able to pursue this new constituency while maintaining a dense and very active internal organization and its programmatic ties to its core constituency. The FA's capacity to develop and sustain a devoted network of partisan activists working in every locality of the country was pivotal in this last regard, especially when traditional partisan structures atrophied.

In short, the social and political opportunity structures that emerged in Uruguay during the 1990s helped the FA develop its strategy successfully. Institutionally, support for the two traditional parties slowly eroded, and no challenger emerged to the left of the FA. The FA capitalized on those enabling conditions by pursuing a complex pattern of partisan adaptation, both segmenting its linkage strategies to attract different constituencies and effectively unifying those segmented linkages.

When the performance of the party is analysed across social segment groups, it becomes clear that voter support grew differentially and unevenly across distinct social strata (see Luna 2014).¹⁸ The FA's constituency has therefore come together steadily but unevenly. Responding to different social-political processes and to the party's changing capacity to link to them by engaging in new types of mobilization strategies, different social segments were drawn towards the FA at different times, and the trend was more rapid with some social sectors than others. The party's peripheral constituency was attracted to the FA later and on the basis of a different set of linkage strategies than the party's core constituency.

Even if we have treated the FA as a unified actor, we must stress that the party is highly factionalized (as are other mainstream parties in Uruguay). It should also be noted that different party factions allow the party to reach distinct electoral segments in the Uruguayan population (Luna 2007). That 'segmented' mobilizational capacity (Luna 2014), allowed FA to expand its original, labour-oriented mass party organization to a catch-all electoral professional party that was also able to reach non-working-class subordinated sectors hitherto mobilized clientelistically by Uruguay's two traditional parties (Panizza 1990). As a result, by the time of the transition to

¹⁸ See Moreira (2000 and 2005) for a parallel argument.

democracy, the party's core constituency was composed of organized labour, as well as a series of organized interest groups ranging from university students to the cultural intelligentsia. During the 1990s, the FA allied not only with labour unions, but also with pension-beneficiary organizations in efforts to derail market reforms in the country. Such early diversification aside, organized labour was clearly a key player within the party's core constituency.

As in the case of the UDI, the core constituency of the party has two consequential characteristics. First, it is not sizable enough to constitute a winning electoral base on its own. Indeed, given the decline of organized labour in Uruguay, the core constituency of FA was logically in danger of shrinking. Expanding the party's electoral constituency to new social segments was therefore imperative.

Second, and also like the UDI, the core constituency of the FA was able to provide resources that became fundamental in structuring new types of linkages to a peripheral (but much needed) electoral constituency. Yet, unlike in Chile, the core constituency of the FA did not provide enough financial resources to disproportionately favour the electoral bid of the party.

Instead of financial resources, the core constituency of the FA provides the party with a militant activist network significantly outnumbering those of traditional parties. In exchange for its core constituency's unrelenting support, during the 1990s the FA led the opposition to market reforms proposed by both traditional parties. These reform efforts included attempts at privatizing public enterprises and subsequent attempts at pension, education, and health reform. In a representative democracy escaping the patterns of hyper-presidentialism and delegation prevalent in the region in the 1990s (O'Donnell 1996), organizations of ISI beneficiaries allied with the FA to oppose attempts at market reform.

However, the same 'veto-coalition' that helped the coalition grow in the 1990s also complicated the enactment of progressive tax reforms once the party arrived into office. In a nutshell, those who were able to perforate the party's tax reform proposal (which would have favoured the party's peripheral constituency, as well as workers in the private sector) are members of its core constituency. In other words, the party now draws support from a socially diverse constituency that can be schematically portrayed as composed of groups having contrasting interests and diverging degrees of organization. Professionals and other white-collar groups, traditionally favoured by special benefits and loopholes, represent a major source of conflict for the FA with respect to the enhancement of progressive redistributive reforms. Yet, the FA has been able to hold together, successfully claiming the presidential re-election in 2009 and in 2014. Electoral success has nonetheless been a mixed blessing, as the party could not implement progressive reforms in pivotal policy sectors such as education and tax reform.

6 Conclusions

This paper shows how powerful elite groups managed to shape legislation in ways that deflected their tax burden. Although political conditions under which reforms are processed change both between countries and within countries over time, the case studies we develop in this paper illustrate the logic of instrumental power exercised by well-organized groups (professionals in Uruguay, business in Chile) that are able to articulate long-term political coalitions with pivotal partisan actors.

The analysis also suggests how a stable democratic environment—in terms of constitutional rule and political actors—allows the Chilean centre-left coalition to persist with a reform agenda and to obtain gradual cumulative results. In both the Chilean and Uruguayan cases, the iterative logic

of gradual reforms and burden deflection of governments and elites also suggests how narrowing social distances entails a long-term process, which is hard to accomplish in the absence of stable constitutional rule. That process usually involves gradual improvement of state capacity and political dialogue between governments and elites.

The case of Chile is particularly illustrative of the importance of building bridges between political actors and powerful elites over the long run. Although elites do not renounce their goal of deflecting their tax burden—as post-reform loophole attempts suggest—the gradual schedule of the 2014 reform may only be possible in an environment in which repeated interaction builds confidence among actors. However, this same characteristic may also suggest that both taxation and redistribution in Chile will remain low, following the type of fiscal equilibrium we observe in North America.

The case of Uruguay suggests another dynamic in which elites seem to be entrenched in their special benefits while governments with a redistributive zeal produce spurts of redistribution throughout comprehensive reforms such as that of 2006. In this case, coalitions tend to be narrower than in the Chilean case, both for reformers and for defectors. Overall, the scenario suggests a fiscal equilibrium in which big government is combined with high taxation. However, the strategy followed by elites to defend loopholes and subterfuges, capturing the loyalty of small groups of politicians in all parties, suggests a less redistributive outcome, in line with the cases of Southern Europe: a sub-optimal equilibrium.

Overall, the analysis illustrates elites' political capacity to shape legislation via their capacity to influence political actors over repeated interaction. The analysis reveals the importance of continuous political agency on the part of organized elite interest groups and shows how even centre-left parties competing on a redistributive programmatic platform confront and concede to the interests of wealthy elites, mostly when sustained interaction between political leaders and economic elites is routinized in the long run.

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