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CHAPTER 3

The Political Economy of Colombia’s 2012 and 2014 Fiscal Reforms

Gustavo A. Flores-Macías

Colombia’s 2012 fiscal reform (Ley 1607 de 2012, December 26) was different from most others in the country and elsewhere in Latin America in that it did not respond to the need to generate additional revenue in the short to medium terms. Instead, the reform’s main objective was to rebalance the fiscal burden—both horizontally (across different types of activities) and vertically (related to different levels of income)—in order to promote progressivity and formal employment, which in turn were expected to lead to accelerated growth. Among the main factors behind the 2012 reform were the government’s legislative majority and its ability to frame the reform in terms of revenue neutrality and employment generation. This strategy allayed concerns about an increased fiscal burden, turned labor-intensive industries into clear winners from the reform, and made the reform’s fight against informality a common cause among the business sectors.

In the final days of 2014, however, Colombia was again embroiled in a debate over the need for fiscal reform, for the second time in less than two years. Due to declining oil revenue, the government’s promise to increase spending in education and infrastructure, and the scheduled sunsetting of two important sources of tax revenue, President Juan Manuel Santos’s administration found itself with a projected fiscal gap of about 2.4 percent of gross domestic product (GDP). Constrained by a fiscal rule and facing potential expenditures associated with the conclusion of the peace process,
the government introduced a revenue-generating reform aimed mainly at preserving the taxes on wealth and financial transactions. As of this writing, in November 2014, the proposed reform was modest; rather than adopting structural reforms or improving progressivity, it focused on the continuation of taxes set to expire.

This chapter outlines the main features of the 2012 reform, discusses key factors that contributed to its adoption, and provides lessons derived from this experience. Additionally, it introduces the contours of the 2014 reform, its main drivers, and potential outcomes based on information available at the time of writing.

COLOMBIA’S 2012 REFORM: ADDRESSING INEQUALITY, UNEMPLOYMENT, AND EVASION

Three main objectives of Colombia’s 2012 fiscal reform are worth highlighting from a political economy perspective. The first and perhaps most important objective was to reduce the inequalities generated by the tax code. The second was to promote the generation of employment and discourage informality. The third was to reduce the levels of tax evasion. Each is discussed in turn in the following paragraphs.

Reducing Inequality

A key objective of the 2012 reform was to reduce inequality in the tax system. Colombia is the seventh most unequal country in the world, based on the Gini coefficient—a measure of the income distribution ranging from 0 to 1. Although fiscal policy can be a useful tool to address income inequality, in Colombia its contribution to ameliorating inequality has been very limited. Whereas for countries that belong to the Organization for Economic Cooperation and Development (OECD), the difference in Gini coefficients before and after taxes and transfers is considerable, in Colombia this difference is negligible. As figure 3.1 suggests, fiscal policy in Colombia—and other Latin American countries—does not contribute much to the redistribution of income and is far from the effect seen in most OECD countries.

An important factor contributing to the ineffectiveness of fiscal policy as a redistribution tool is the lack of progressivity in the income tax. For example, those salaried workers with the lowest levels of taxable income would pay a higher effective rate than those with higher levels because the latter would be required to file a tax return and could take advantage of deductions. Higher-income groups also enjoyed a greater number of deductions, exceptions, and other prerogatives. Further, salaried income tends to be subject to tax withholding at the source, whereas higher incomes from capital are not subject to withholding and thus are conducive to higher evasion rates. As a result, those at the highest income levels would often pay less than 1 percent of their annual income.

To make the system more progressive, the reform introduced the National Minimum Alternative Tax (Impuesto Mínimo Alternativo Nacional, IMAN), a presumptive tax that taxpayers must calculate and that establishes a tax...
Once all exceptions and deductions have been taken into account, the IMAN was intended to prevent the sectors with the highest levels of income from drastically reducing their tax burden due to fiscal prerogatives. This would also bring a dose of horizontal equity, reducing the differences in effective taxes paid by taxpayers with similar income levels. Therefore, the IMAN sought to improve the progressivity of income taxes—with rates ranging from 0 to 27 percent—while providing a floor for fiscal revenue. In particular, those making less than CO$3.35 million (US$1,706 per month) are not required to pay income tax, and taxpayers would have the option of paying instead the Simple Minimum Alternative Tax (Impuesto Mínimo Alternativo Simple, IMAS)—a slightly higher but definitive and more easily calculated presumptive tax. The government expected the reform to decrease the country’s Gini coefficient by 2 points, from 0.57 to 0.55.

**Encouraging Formal Employment**

A second major objective of the reform was to address informality by encouraging the generation of formal employment. Informality is a problem because it prevents firms from becoming more productive and people from realizing their employment potential and accessing employment benefits, both of which in turn hinder growth and development. It also reduces the government’s fiscal intake, which affects the quantity and quality of the public goods provided by the government. Figure 3.2 illustrates the extent of informal employment.

The government identified an excessive burden on corporations as one of the main factors contributing to informality. This rests on the premise that payroll-related costs are the main impediment to scaling up and consolidating a business in the formal sector. These costs are problematic for employment generation because they disproportionately affect those companies with the largest number of formal employees by increasing variable costs.

Before the reform, nonwage costs corresponded to 51 percent of a worker’s salary, of which about a fifth was taxes and the rest was expenses related mainly to health care, pensions, and holidays. These nonwage taxes, dubbed *parafiscales* in Colombia, had been the main source of funding for the country’s National Apprenticeship Service (Servicio Nacional de Aprendizaje, SENA)—a government agency in charge of devising programs for workers’ educational development—and the Colombian Institute for Family Welfare (Instituto Colombiano de Bienestar Familiar, ICBF)—a branch of the Ministry of Social Protection whose mission is to provide social protection to the family in general and children in particular. To alleviate the payroll-related burden on corporations with employees whose salary is up to ten times the statutory minimum wage, the reform eliminated part of the fiscal burden from the *impuestos parafiscales*—the tax of 13.5 percent on payrolls associated with benefits from the ICBF (3 percent), SENA (2 percent), and the Sistema de Salud (Health Care System) (8.5 percent), which cover the entire population.

In order to maintain funding for these benefits, the reform created the Income Tax for Equity (Impuesto Sobre la Renta para la Equidad, CREE), which is levied on net corporate income at a rate of 9 percent for the first...
three years—until 2015—and subsequently at a rate of 8 percent. The extra percentage point adopted until 2015 is earmarked for higher education (40 percent), health care (30 percent), and agriculture (30 percent). However, the introduction of the CREE was generally offset by a decrease in the corporate income tax from 33 to 25 percent. This way, the total corporate income tax burden on business remained at 33 percent, as it was before, but the reduction of the burden from *parafiscales* was important for stimulating the generation of formal employment.

In particular, the reform partially decoupled the payroll tax from the benefits provided by the ICBF, SENA, and Sistema de Salud, so that the decision to employ an individual would be less affected by this fiscal consideration. Instead, these benefits would be partially funded by all corporations based on their taxable income through the CREE. The government expected this reduction in 13.5 percentage points in non-salary-related costs (*costos no salariales*) to translate into an 11 percent increase in formal employment (between 400,000 and 1 million new jobs in the formal sector) and a 10 to 15 percent increase in the relative size of the formal sector.7

**Curbing Tax Evasion**

The 2012 reform also took steps to discourage evasion by simplifying the tax code and consolidating existing value-added tax (VAT) rates. For example, it limited corporations’ ability to deduct interest payments on liabilities that exceed three times the value of their liquid assets. This was intended to dissuade companies from setting up "ghost" debt structures, often carried out by sister companies abroad, that allow them to deduct several times the company’s worth. The reform also identified a list of countries as fiscal havens and required that all transactions taking place with any party in these countries be reported and subject to the transfer pricing regime. This was meant to discourage the practice of reporting transactions with entities in fiscal havens below market prices, in order to avoid paying taxes in Colombia and then selling at market prices in the fiscal haven in order to receive a lower tax bill.8

Additionally, the reform simplified the VAT—which in Colombia has been characterized as having low productivity and contributing to horizontal inequity. It consolidated the seven existing rates of 0, 1.6, 10, 16, 20, 25, and 35 percent into three: a generalized standard rate of 16 percent for most goods and services; a reduced rate of 5 percent for some goods, such as prepaid medicine and many agricultural products; and 0 percent for exempt goods and services, such as education. This should simplify the administrative burden for taxpayers and aid efficiency in oversight and collection for Colombia’s tax collection agency—the Dirección de Impuestos y Aduanas Nacionales.

The new law also created an excise tax on the consumption of certain goods. This tax was intended to compensate for the forgone tax revenue from reducing some of the higher VAT rates and to discourage the consumption of certain goods because of negative externalities. Examples of goods subject to this tax are automobiles (8 percent, if the price is less than US$30,000, and 16 percent otherwise) and cellular communications (4 percent). Moreover, the reform also replaced the VAT on restaurants with an 8 percent consumption tax in order to simplify tax compliance—because the consumption tax is less administratively complex than the VAT—and to discourage informality.9

In short, the 2012 reform presented a series of measures meant to address important shortcomings of the Colombian tax system. Rather than increasing fiscal revenue as the main objective—as the previous reform in 2010 had done—this reform had progressivity, employment generation, and simplification of the tax burden as guiding principles.10

**THE DRIVERS OF COLOMBIA’S 2012 REFORM: STRUCTURAL, POLITICAL, AND CONJUNCTURAL FACTORS**

Colombia’s 2012 reform took place in the midst of a favorable economic context and the aftermath of a series of successful revenue-generating reforms, both of which are central factors to understand the revenue neutrality and redistributive nature of the measure. Although at the cost of concessions to different interest groups in order to make the changes politically palatable, reforms throughout the previous decade—in 2003, 2006, and 2010, among others—had addressed the need to cover budgetary gaps.11 Given the increase in public spending since 1991 as a result of the government’s
obligations set forth in the new Constitution and the urgency of financing the security apparatus, previous fiscal reforms had steadily increased fiscal revenue over time.\textsuperscript{12}

The adoption of these reforms, as well as the gradual improvement of security conditions since 2002, contributed to increasing Colombia’s appeal to foreign investors and improving economic conditions. In particular, the consistent ability to raise fiscal revenue and the transparency brought about by important measures in the fiscal realm—for example, the adoption of the Fiscal Transparency and Responsibility Law and the Medium-Term Fiscal Framework (Law 819 of 2003) and the quantitative fiscal rule (Law 1473 of 2011)—translated into increased investor confidence and led credit-rating agencies to grant investment grade to the Colombian government’s debt for the first time since 1999. Buoyed by these factors, and with the help of a hydrocarbons and mining boom, the economy grew by 6.6 percent in 2011, 4.05 percent in 2012, and 4.26 in 2013, a performance much better than the regional average of 4.3 percent, 2.9 percent, and 2.5 percent, respectively.\textsuperscript{13} In this context, the government considered these conditions ideal for pushing for an ambitious reorganization of the tax system.

However, though the string of successful reforms in previous years and the auspicious economic context might explain the objectives of the reform, they are less helpful in accounting for the prerogatives that the final text granted to some and took from others in the process of pursuing its main objectives. Despite the period of relative economic stability and good performance, the approved reform was fairly different in scope from the one originally proposed by the Santos administration. When President Santos and his finance minister, Juan Carlos Echeverry, first announced the government’s proposal for a fiscal reform early in 2012, they characterized it as one that would “make the rich and tax evaders cry.”\textsuperscript{14} Complicating the prospects for the reform, however, a leaked draft of the proposal galvanized opposition even before Minister Echeverry formally presented the initiative to Congress.

Above all, the government’s initial proposal sought to carry out a comprehensive structural fiscal reform, dubbed ELISSA—for equidad, limpieza, sencillez, seducción y adaptación internacional, which roughly translates as equity, transparency, simplicity, appeal, and adaptation to international standards. The proposal was ambitious in its attempt to reorganize and simplify the tax code, aiming to reduce the number of the code’s articles by a fourth, from 1,200 to 900.\textsuperscript{15} It also introduced several changes that were similar to those ultimately approved by Congress as part of Law 1607 of 2012. These included reducing the general corporate income tax rate—from 33 to 27 percent, in the original proposal—introducing the presumptive IMAN for individuals and corporations, simplifying the VAT to a general 16 percent rate, and adopting a consumption tax on luxury goods.\textsuperscript{16}

However, several important aspects of the proposal were modified or eliminated because of opposition among different interest groups and legislators in Congress. For example, the plan to introduce a 4 percent tax on dividends faced strong antagonism from the business community. Leading the effort against the measure were the Consejo Gremial—a semiformal union of the country’s most important business associations\textsuperscript{17}—as well as the Asociación Nacional de Empresarios de Colombia (ANDI; National Business Association of Colombia) and the National Association of Brokerage Firms.\textsuperscript{18} In a letter addressed to Congress, Consejo Gremial president Rafael Mejía stated that the dividends tax would unfairly “constitute double taxation, first on corporations and again on shareholders.”\textsuperscript{19} Similarly, the plan to limit deductions related to housing and voluntary contributions toward pensions for salaried workers encountered significant opposition in Congress because it would have disproportionately affected salaried workers compared with those deriving income mainly from capital gains.\textsuperscript{20} The plan to tax pensions among the wealthiest sectors, excluding those up to CO$13 million (US$6,600), was opposed by both business groups and legislators, because the measure would have mostly affected the pensions of top business executives, members of Congress, and court justices.\textsuperscript{21}

Whereas these considerations were mainly opposed by the business sector, the most prominent aspect facing generalized opposition was the proposal to adopt a 5 percent VAT for basic consumption items such as rice, milk, and meat and for some agricultural products, while seeking to compensate the lowest income sectors with food vouchers or other benefits. In line with other Latin American countries’ experiences, in Colombia this proposal encountered severe criticism from many fronts. For example,
the president of Colombia’s Cattle Ranchers’ Association characterized the measure as absurd because it would increase the cost of living and push many into the informal sector.22 Echoing this view, Simón Gaviria, the leader of the Liberal Party (Partido Liberal), stated that the measure would have a negative impact on the lower and middle sectors, which would run counter to the spirit of the reform to make paying taxes more equitable. Therefore, he warned that his party would oppose the reform if this measure were included. Upon the generalized negative reaction against the 5 percent VAT, President Santos himself withdrew his support for the measure due to the political cost the measure could bring in subsequent elections.

Adding to the friction between the government and the different sectors of society generated by the initial proposal, the government was emerging out of a period of strained relations with Congress. When President Santos was first elected, he put together a heterogeneous coalition comprising the main parties in Colombia, including the Social Party for National Unity (Partido de la U), the Conservative Party, the Liberal Party, and the Radical Change Party. This legislative coalition, dubbed the Coalition for National Unity, enjoyed a comfortable majority in Congress, having won about 80 percent of the seats in the legislature. In particular, Santos’s own party, Partido de la U, was the main political force, with about 28 percent of the senators and 28 percent of representatives, followed by the main coalition partner, the Conservative Party, with 22 percent of senators and 23 percent of representatives. However, the coalition also represented a diversity of actors and interests, including the Liberal Party—which had been in the opposition during President Álvaro Uribe’s administration—and the General Labor Confederation (Confederación General del Trabajo) and other labor groups supporting Santos’s vice president, labor leader Angelino Garzón.

The government coalition was tested when President Santos had vetoed a controversial constitutional reform to the justice system in the previous months on the grounds that it included unacceptable privileges for legislators and former government officials.23 The confrontation had soured executive-legislative relations to the point where some legislators were seeking to impeach the president, with several legislators—both outside and within the coalition—feeling that the government was responsible for leaving Congress to fix a poorly drafted and highly controversial justice reform.24 In this context, the Santos government opted for postponing the fiscal reform.25

The government’s window to introduce meaningful reforms was closing as President Santos entered the second half of his first four-year term. Pushing for a fiscal reform in 2013 would be harder because of the proximity of parties’ primaries in anticipation of the 2014 elections. A few months later, however, the new finance minister, Mauricio Cárdenas, modified the reform proposal to give it a less ambitious scope. Instead of structural reform, the aim would be to make the tax burden more equitable and to promote formal employment. After formally presenting the revised proposal to the legislature in October, Congress and different interest groups voiced concerns about the new text. Rather than having the discussion take place in the legislature, the government then withdrew the proposal to take into account this dissent and reintroduce the text with modifications. Table 3.1 summarizes the 2012 fiscal reform proposals.

This revised proposal also met opposition in Congress. Among the opposition sectors, union representatives in general and the Alternative Democratic Pole (Partido Polo Democrático, PDA) in particular criticized the reform for favoring corporations and the wealthy and running contrary to the lower and middle classes. For example, PDA senator Jorge Robledo argued that the reduction of the income tax from 33 to 25 percent translated into a benefit of CO$8 billion (US$4.1 million) for big business.26 The PDA also denounced the elimination of the taxes on dividends and on pensions on the wealthy as evidence that the government and its legislative coalition in Congress were bowing down to the interests of the affluent. Overall, the PDA argued that, even though President Santos had reiterated that the middle class would not be affected, the 2012 reform was less about equity and more about favoring growth among certain sectors.

Conversely, the government argued that the reduction of the fiscal burden on corporations was essential to generating formal employment and increasing growth. Highlighting the national unemployment rate, which hovered above 10 percent in 2012, the government expressed concern about the negative consequences of the steady appreciation of the Colombian peso because of the influx of hard currency related to mining activity. The main
change for labor-intensive industries—including retail, agriculture, fisheries, construction, textiles, wholesale, and transportation—which were expected to see a decrease in the fiscal burden related to their employees by as much as 4 percentage points. Not surprisingly, some of the main advocates of this measure were representatives of the manufacturers of automobiles and auto parts, as well as of the flower growers’ industry. As Augusto Solano, head of the Colombian Association of Flower Growers (Asocolflores) estimated, the measure could represent an 18 percent decrease in production costs. Similarly, as Luis Carlos Villegas, then president of ANDI, concluded, “The reform is equitable and well thought out. It incorporates many of the fiscal proposals that the private sector has been advancing for decades. It could generate between 850,000 and 1 million formal jobs in the first year.”

Conversely, capital-intensive industries such as mining, utilities, and financial services would now bear more of the burden. In the case of mining the increase in the fiscal burden was estimated at 22 percent greater as a result of the CREE. In the words of Carlos Zuluaga, president of ACESCO (Colombia’s Steelmakers’ Association), “the consequences of several aspects of the reform are unpredictable.” This perspective was shared by COLMINEROS (Colombia’s Miners’ Association), which expressed concern that the fiscal reform would hurt the sector’s competitiveness.

This switch in the burden to favor the labor-intensive sectors was generally well received in the legislature because changes favoring the generation of labor were perceived as translating into votes. Outside Congress, the measure generated some debate, however. In the words of Juan Mauricio Ramírez, vice president of the think tank Fedesarrollo, “Growth by itself does not generate formal employment. The reform makes sense because the ICBF, SENA, and Sistema de Salud will be financed less by small and medium-sized businesses and more by the mining and banking sectors—by companies such as Bavaria, Ecopetrol, Pacific, Comcel (Claro), Cerrejón, and banks such as Bancolombia and Banco de Bogotá.” In the view of Argentina’s former minister of finance, Domingo Cavallo, who served as an adviser to the government, “this change by itself makes the reform worth it.” Others were skeptical, such as the economist and banker Mauricio Cabrera, who argued that the decrease in costs would translate into greater profits rather than more employment, because the elasticity of

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**Table 3.1. The 2012 Fiscal Reform Proposals**

<table>
<thead>
<tr>
<th>Echeverry’s Reform</th>
<th>Cárdenas’s Reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structural reform that reduced the number of articles in the tax code by 25%, from 1,200 to 900.</td>
<td>Mini reform that introduced a law with 102 articles.</td>
</tr>
<tr>
<td>Objective: equity, transparency, simplicity, appeal, international standards</td>
<td>Objectives: equity, formal employment</td>
</tr>
<tr>
<td>Reduction of corporate income tax from 33 to 27%</td>
<td>Reduction of corporate income tax from 33 to 25%, but offset by new CREE tax</td>
</tr>
<tr>
<td>Eliminate exceptions</td>
<td>Exceptions remained unchanged</td>
</tr>
<tr>
<td>VAT on basic consumption goods</td>
<td>No VAT on basic consumption goods, but creates consumption tax</td>
</tr>
<tr>
<td>Tax on dividends</td>
<td>Discarded tax on dividends</td>
</tr>
<tr>
<td>No change to the price of gasoline</td>
<td>Changes to the price of gasoline and diesel</td>
</tr>
</tbody>
</table>

*Source: Based on information from Observatorio Legislativo, Reforma Tributaria, boletín de seguimiento 209, Instituto de Ciencia Política, November 2012.*
the demand for labor is very low. In his view, this would be a drop in the bucket compared with the real drivers of informality and the considerable currency appreciation of the last decade. Yet others agreed with the reform but lamented the earmarking of the CREE, which responded to the need to maximize the political feasibility of reform.

Some of the criticism against the reform for favoring the affluent sectors also came from within the government coalition in Congress. Some legislators from the Liberal Party expressed concerns about specific aspects of the government’s plan disproportionately affecting the lower and middle classes. For example, Partido Liberal senator Camilo Sánchez denounced the proposal to adopt a consumption tax on restaurants serving low-income sectors, particularly those providing low-income breakfasts—known in Colombia as corrientazo. Similarly, Liberal Party leader Simon Gaviria pointed out that the government’s proposal to introduce the IMAN would result in an effective rate increase of up to 45 percent for those taxpayers making monthly incomes between CO$3.36 million and CO$6 million (between US$1,700 and US$3,100). Another criticism of the IMAN was that it would make filing taxes even more complicated, which ran counter to the simplifying impetus of the reform. Moreover, Radical Change Party senator Daira Galvis expressed skepticism that reducing the tax burden on corporations would translate into formal employment.

In response, Finance Minister Cárdenas dismissed the characterization that the reform disproportionately affected the lower and middle sectors. He pointed instead to the reform’s protection of these sectors by setting a threshold of about CO$3.5 million (about US$1,750) to start withholding at the source and commended Congress “for protecting the interests of the Colombians in the lowest income levels.”

In response, Finance Minister Cárdenas dismissed the characterization that the reform disproportionately affected the lower and middle sectors. He pointed instead to the reform’s protection of these sectors by setting a threshold of about CO$3.5 million (about US$1,750) to start withholding at the source and commended Congress “for protecting the interests of the Colombians in the lowest income levels.”

Culminating a special legislative period convened by President Santos, on December 21, 2012, Congress overwhelmingly approved the fiscal reform. Fifty-two senators voted in favor and only 6 voted against. In the lower chamber, 104 representatives gave their support, whereas 10 registered their opposition to the law. Upon the approval of the law, Finance Minister Cárdenas stated that “the reform will allow Colombia to stop being one of the most unequal countries in the hemisphere, since it will bring more equity and formal employment.” He added that, in spite of the net loss in yearly revenue of about CO$500 billion to CO$700 billion (between US$280 million and US$400 million) that would result from the changes the legislature made to the government’s initiative, the reform was nonetheless a considerable step forward.

On balance, both the least and the most affluent sectors saw their interests protected in the final version of the reform, but the middle class was the least favored by it. This is because the working sectors’ interests were championed in the legislature by the PDA, and the rich were well organized to make their voices heard and enjoyed representation across the government’s coalition. Conversely, the middle classes were at a disadvantage because they have a more diverse set of interests and are less able than economic elites to evaluate the impact of the reform. For these reasons, the middle sectors were unable to find a champion that would push back on their behalf. Moreover, the middle sectors are more likely to have their salary income withheld without many of the compensatory mechanisms benefiting the poor.

LESSONS FROM THE 2012 REFORM

Overall, the 2012 law represents a pragmatic approach to fiscal reform. It was gradual and not particularly ambitious, but it was politically feasible and allowed for smaller and consistent steps in the desired direction. Naturally, the reform fell short of achieving many changes the government had initially deemed desirable. Ideally, the reform would have also increased fiscal revenue to finance both mounting commitments related to education and infrastructure—as President Santos had promised during his campaign—and the potentially successful conclusion of the peace process, which was likely to be financially very onerous. These resources could have come from the elimination of the special tax zones (zonas francas), the adoption of taxes on pensions of the wealthy and on dividends, and the reduction of the myriad exceptions to the VAT that constitute a patchwork of fiscal prerogatives for different interest groups.

Similarly, the reform could have applied the IMAN across the board, regardless of whether the taxpayer was a salaried worker, while eliminating additional deductions that benefit the wealthy. It could have attempted to
get rid of distortionary taxes, such as the wealth tax and the tax on financial transactions, which, respectively, discourage savings and investment and the use of formal financial institutions. The reform could also have attempted to establish a CREE without unnecessarily constraining the destination of its revenue with the earmarking for the ICBF, SENA, and Sistema de Salud.

However, Minister Echeverry’s failed attempt at comprehensive reform showed that a truly structural fiscal reform is bound to encounter significant opposition from a number of fronts. In the absence of a major crisis that forces the main political forces to agree on a grand fiscal bargain, this approach risks sacrificing any progress altogether. Instead, the success of Law 1607 of 2012 was mainly due to the pursuit of more limited reform, pitched not as a game changer but as a necessary, limited step in a longer series of adjustments.

In addition to the government’s strategy of understating the nature of the reform and setting expectations low in its revised formulation, three main factors proved important in securing its approval in Congress. First, the government was able to deactivate opposition and even gain supporters among the working sectors and their representatives in Congress by emphasizing the revenue neutrality of the reform and the generation of employment. The first feature conveyed the sense among the population that the government did not intend to exert a greater fiscal burden on society, regardless of whether specific sectors inevitably lost from the reform or whether a revenue-generating reform would likely be required in the near future. The second made the promise of greater employment an appealing banner for legislators to embrace before their constituents.

A second important factor relates to the government’s ability to identify labor-intensive industries as the clear winners from the reform. This numerous group proved instrumental in the government’s building of a coalition of allied forces by providing both a lobbying arm in Congress and contributing to winning over public opinion. Conversely, capital-intensive industries such as mining and banking—which were among the losers of the reform—tend to be less favorably viewed by the public and less able to translate their opposition into public pressure on legislators. The stated objective of the reform to address informality also gave the business community in general a stake in the proposed changes.

A third strategy that contributed to the success of the reform was the government’s decision to withdraw the initial reform proposal after encountering opposition among legislators once Minister Cárdenas’s initiative was formally introduced in Congress. Rather than risking that the different political forces make significant changes to the initiative, the government adjusted the text to incorporate dissenting views while maintaining the general coherence of the proposal with an emphasis on revenue neutrality. Avoiding piecemeal discussion of the proposal contributed to the approval of a final text that was fairly close to the one the government had presented after taking into account legislators’ opinions.

Notwithstanding these strategic successes, a fundamental underlying factor facilitating the adoption of the reform was the existence of a majority in Congress behind the president’s initiative. Despite the rift between President Santos and the legislature over judicial reforms to the Constitution a few months before the discussion of the fiscal reform, the president’s legislative majority played a decisive role for the reform’s approval. Although not every vote from the Partido de la U, Conservative Party, Liberal Party, and Radical Change Party was guaranteed, there was relatively little uncertainty as to whether the Coalition for National Unity would ultimately garner enough votes to adopt a fiscal reform along the general lines of what Minister Cardenas’s proposal had outlined.

FROM REVENUE NEUTRALITY TO REVENUE GENERATION: THE 2014 FISCAL REFORM

Almost two years after the adoption of the 2012 reform, the government’s Medium-Term Fiscal Framework projections pointed to a budget gap of about 2.4 percent of GDP. This estimate was based on the expected decline in oil production, the phasing out of the tax on financial transactions (from COP4 per 1,000 pesos to COP2 per 1,000 pesos beginning in 2015) mandated by Law 1410 of 2010, and the sunsetting of the wealth tax originally intended to pay for the government’s security efforts. The forgone income from these two taxes accounts for about 55 percent of the projected fiscal gap—1.3 percent of GDP. Whereas oil production had increased in
Colombia until it reached a peak of 1.1 million barrels per day in 2012, it is expected to decline to well under 1 million barrels per day, along with greater production costs. Combined with a lower expected price of the Colombian basket, this will represent lower revenue for government coffers. Guerrilla attacks during the first half of 2014 on the country’s oil infrastructure only magnified the problem.

On the expenditures side, although not explicitly considered in the fiscal framework’s projections, government spending is likely to surpass expected levels because of the financial burden related to President Santos’s campaign promise to increase investment in education and infrastructure, and because of potential commitments resulting from the peace negotiations with the Revolutionary Armed Forces of Colombia (Fuerzas Armadas Revolucionarias de Colombia) in Havana. However, the bulk of the spending that exceeded projections came from the government’s operating costs, which increased by 12 percent from the previous year. Additionally, expenditures related to pensions grew faster than expected. The government’s reduction of investment expenditures by 5.5 percent was not enough to compensate for the increase in spending.

The government’s policy options are constrained by the “fiscal rule” adopted in 2011 (Law 1473 of 2011). Conceived as a mechanism to avoid procyclical fiscal policies, the Law’s Article 5 establishes that structural expenditures may not exceed structural revenue by more than the preestablished goal set for the structural balance. The rule establishes a limit for the structural deficit of 1 percent of GDP by 2022, and a transitional period with more moderate ceilings—2.3 percent by 2014, 1.9 percent by 2018, and 1 percent by 2022 and beyond. Given that the estimated fiscal gap amounted to about 17 percent of expenditures and exceeded the deficit allowed by the fiscal rule, the government was faced with two main revenue-generating options to cover this gap. The first was to push for a comprehensive revenue-generating fiscal reform—despite President Santos’s opposing this during his reelection campaign. The second was to postpone the expiration of the wealth tax and the phasing out of the financial transactions tax to address the country’s short-term financial needs.

The government first floated a reform to renew the wealth tax and postpone the phasing out of the financial transactions tax for another four years. This early proposal intended to raise the maximum marginal rate for the wealth tax from 1.5 to 2.25 percent and establish a progressive tiered rate. In particular, the wealth threshold to pay the tax would decrease from CO$1 billion to CO$750 million (from about US$500,000 to US$380,000). The marginal rates would be 0.4 percent for wealth between CO$750 million and CO$3 billion (US$380,000 to US$1.5 million); 1.1 percent for wealth between CO$3 billion and CO$5 billion (US$1.5 million to US$2.5 million); 2 percent for wealth between CO$5 billion and CO$8 billion (US$2.5 million to $4 million); and 2.25 percent for larger amounts.

Even before the government formally presented the initiative to Congress, however, several sectors expressed dissatisfaction at this early stage. For example, the president of the National Federation of Merchants (Federación Nacional de Comerciantes), Guillermo Botero Nieto, complained that “there have been considerable updates on property value carried out in the registry since 2011, and the renewal of the wealth tax would have an impact on the productive sector in a sudden way.” He also urged the government to reduce current spending, particularly on the bureaucracy, and opposed preserving the tax on financial transactions because it runs against the push for incorporating businesses into the formal banking sector. Similarly, the head of the chocolate maker Grupo Nutresa expressed frustration that the government would resort to more taxing of the same narrow base with every reform and urged the government to instead expand the base. Along the same lines, Carlos Eduardo Botero, head of the Institute for Exports and Fashion (Indexmoda), exhorted the government to put an end to the black market and informal trade rather than raising taxes.

Many of these opposing views interpreted the need for additional revenue as a failure of the 2012 reform. They pointed to the steady decrease in the yearly rate of growth in fiscal revenue, from 25 percent in 2011 and 15 percent in 2012 to 7 percent growth in 2013, and attributed this decline to the reduction in the corporate tax rate from 33 to 25 percent. Among the most salient critics was the current head of ANDI, Bruce MacMaster, who criticized the government’s proposal for failing to address more long-term fiscal problems, including the causes of declining oil revenue.

This opposition was not shared by all business sectors, however. Supporters among the business associations included Julián Domínguez Rivera, leader of...
the Confederation of Chambers of Commerce (Confecamaras), and Arturo Gutiérrez de Piñerez, the head of the gas company Gases de Occidente, who argued that these taxes are a continuation of the fiscal burden to which Colombians are accustomed, and are therefore not problematic. In their view, what is important is that the government continue to invest in education. However, they also argued that the government would need to do a good job of cracking down on tax evasion and not generating any more taxes.60

Others even advanced their own alternative proposals. For instance, Colombia’s Exporters Association (Analdex) proposed maintaining the wealth tax without changes to the base or rate, because the real appreciation of real estate would bring even more revenue to the government. It also advocated maintaining the financial transactions tax. Further, its main proposal was to raise the generalized VAT rate from 16 to 17 percent, which it argued would prevent having to carry out yet another reform in a year or two, because revenue from oil and mining is likely to continue to decrease.61 This proposal was similar to the one advanced by the Association of Financial Institutions (Asociación Nacional de Instituciones Financieras), which favored phasing out the tax on financial transactions but suggested instead increasing the VAT rate by 1 percentage point for two years, and by 2 percentage points, to 18 percent, starting in 2017.

Some of these views were echoed in Congress, with several legislators expressing concern about the government’s early plan. For instance, María del Rosario Guerra, senator from the Democratic Center—a right-of-center party formed in 2013 by former president Uribe and that became the main alternative to Santos in the 2014 presidential race—pointed out that “the approval of expenditures without securing ways of financing is worrisome, particularly when the president never spoke of raising taxes during his campaign. I see a lot of improvising.”62 Others, such as Green Party senator Antonio Navarro, favored eliminating deductions for mining companies and adopting a 5 percent tax on dividends.63 The Alternative Democratic Pole, through statements by Senator Jorge Enrique Robledo and Representative Alirio Uribe, condemned the government’s tendency to tighten the belt on labor and the middle class while reducing the tax burden for corporations in previous reforms and strongly rejected any attempt to raise the VAT to 18 percent.64 In this regard, even the president’s own party sounded a note of caution. As Senator José David Name, president of the Senate, stated, “Colombia cannot keep burdening the middle class with more taxes.”65

In light of this opposition, Minister Cárdenas indicated that his preference would be to make permanent the tax on financial transactions and the wealth tax in order to sustain current levels of investment in education and poverty reduction.66 Although improving on these levels will require finding additional resources in the future, beyond what the preservation of these two taxes could bring, the Santos administration’s final proposal excluded both the dividend tax—which had been a contentious point in the 2012 reform—and an increase in the VAT to minimize animosity toward the reform among economic elites and their allies in Congress.

Instead, the final text of the initiative presented to Congress in October 2014 focused on three main issues: (1) adopting a wealth tax for another four years, (2) postponing the phasing out of the tax on financial transactions, and (3) and creating a surcharge for the CREE.67 First, the wealth tax—whose name in Spanish was modified from Impuesto al Patrimonio to Impuesto a la Riqueza—differed from the government’s early proposal in that the rates were less steep and the threshold to pay the tax remained unchanged at CO$1 billion (about US$500,000). Table 3.2 shows the different marginal tax rates and corresponding taxes associated with each level of taxable wealth. The government expects that 52,000 individuals and 32,000 corporations would be required to pay the tax.68

### Table 3.2. Proposed Wealth Tax in the 2014 Fiscal Reform

<table>
<thead>
<tr>
<th>Wealth (CO$)</th>
<th>Marginal Rate (%)</th>
<th>Tax (CO$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 2 billion</td>
<td>0.20</td>
<td>(Taxable base) x 0.2%</td>
</tr>
<tr>
<td>Between 2 billion</td>
<td>0.35</td>
<td>[(Taxable base - 2 billion) x 0.35%] + 4 million</td>
</tr>
<tr>
<td>Between 3 billion and 5 billion</td>
<td>0.75</td>
<td>[(Taxable base - 3 billion) x 0.75%] + 7.5 million</td>
</tr>
<tr>
<td>Over 5 billion</td>
<td>1.50</td>
<td>[(Taxable base - 5 billion) x 1.5%] + 22.5 million</td>
</tr>
</tbody>
</table>

*Source: Proyecto de Reforma Tributaria, Ley 134 de 2014.*
Second, the financial transactions tax would remain at CO$4 x 1,000 until 2018, instead of it being phased out in 2015, as originally scheduled. It would now be phased out—becoming CO$3 x 1,000 in 2019, CO$2 x 1,000 in 2020, CO$1 x 1,000 in 2021, and disappearing in 2022. Third, the CREE would remain at 9 percent permanently, instead of decreasing to 8 percent in 2015 as scheduled. There would also be a 3 percent surcharge on the CREE for taxable corporate income over CO$1 billion (about US$500,000). The government estimates that 6,000 corporations would be affected by the surcharge.

Although the formal presentation of the government’s initiative elicited statements from ANDI and the oil sector (Asociación Colombiana del Petróleo) calling the reform a setback for small and medium-sized businesses and hindering the oil sector’s contribution to Colombia’s economy, Congress will likely approve a version that is not far from the government’s proposed reform.69 This is because, in spite of the weakening of the government’s coalition and the strengthening of the Centro Democrático in the 2014 legislative elections, President Santos still enjoys a majority in Congress. Additionally, whereas the benefits of progressivity and horizontal equity in the 2012 reform will only be felt in the medium to long runs, there is some preliminary evidence that the government’s efforts have begun to pay off: Employment generation appears to be on the right track following the 2012 reform, with the unemployment rate reaching 9.9 percent of the country’s labor force in 2013—the lowest in twelve years.70 These factors, combined with the modest scope of the reform, are conducive to its approval without much complication for the government. However, the reform’s limited scope might end up being a double-edged sword, because the government is likely to find itself having to revisit the plan for a more ambitious revenue-generating reform in the near future, especially if the peace process comes to fruition.

EPILOGUE

As this book went to print in December 2014, the Colombian Congress approved a new fiscal reform law (Law 1739). The final text of the legislation differed from the government’s proposal in several ways. One important change was that individuals and corporations are treated differently with respect to the wealth tax. Individuals will pay roughly what the government had proposed, with a tiered rate starting at 0.18 percent on income over CO$2 billion (about US$1 million) and a top rate of 1.5 percent on income over CO$5 billion (US$2.5 million) for the 2015-18 period. But corporations will pay the tax for only three years and at lower rates: the top marginal rates are 1.15 percent in 2015, 1.0 percent in 2016, and 0.4 percent in 2017 for incomes over CO$5 billion (US$2.5 million). Moreover, the CREE will remain as proposed—at 9 percent—but the threshold for the CREE surcharge for the 2015-18 period will be on taxable corporate income over CO$800 million (about US$400,000), with rates of 5 percent in 2015, 6 percent in 2016, 8 percent in 2017, and 9 percent in 2018. The tax on financial transactions remained unchanged.71

These changes reflected an intense negotiation between the government and business sectors on the eve of the reform’s approval. Due to intense pressure from Colombia’s main private sector groups, the government conceded a reduction in the wealth tax in exchange for higher corporate taxes through the CREE surcharge in order to cover the projected fiscal gap. The government also committed to pursuing a comprehensive fiscal reform in the future; the final text of the law mandated that a commission be established to evaluate the existing fiscal system and make recommendations.

On balance, the 2014 reform contributed to the progressivity of the system by introducing relatively high thresholds and tiered marginal rates for the wealth tax and the CREE surcharge. It also contributed to closing the projected fiscal imbalance while maintaining existing expenditures on social programs and infrastructure. However, it postponed the elimination of distortionary taxes that discourage financial transactions and savings and missed an opportunity to introduce more ambitious changes to address the decline in oil revenue. The 2014 reform’s limited scope, the continued drop in oil prices (by the end of 2014 oil prices were half of what they were mid-year), and the potential successful conclusion of the peace negotiations will likely set the stage for a more ambitious reform in the near future.
NOTES

3. Ibid.
7. Although some studies challenged the government’s estimates regarding employment generation, preliminary data for 2013 point to an 8.6 percent increase in formal employment and a 2.9 percent decrease in informality. See “El empleo formal crece tras la reforma tributaria,” Portafolio, March 18, 2014; and Stefano Farné and David Arturo Rodríguez, Bajar los impuestos al trabajo genera empleo! Ley 1607 de 2012 de Reforma Tributaria en Colombia, Cuadernos de Trabajo 14 (Barranquilla: Universidad Externado de Colombia, 2013).
18. In comparative perspective, Colombia’s peak business associations are among the best organized and most influential in Latin America, comparable to those in Mexico and Chile. See Ben Schneider, Business Politics and the State in Twentieth-Century Latin America (New York: Cambridge University Press, 2004).
21. Ibid.
29. Ibid.
31. Ibid.
34. Ibid.
35. According to the government’s estimates, the reform would address the currency appreciation associated with Dutch disease by alleviating business’ fiscal burden, which would be equivalent to a10 percent depreciation. Ministry of Finance, Exposición de motivos de propuesta de reforma fiscal 2012, October 2012.
41. The net loss will be a result of Congress’s lowering of the gasoline tax and the changes to the VAT.
43. Salazar, Political Economy.
44. Ibid.
45. The 2014 revenue-generating fiscal reform, which was intended to cover a budgetary gap projected in the government’s medium-term fiscal framework, is discussed in the next section.
46. On July 9, 2014, the Constitutional Court rejected a challenge based on procedural allegations to the 2012 fiscal reform and declared valid Law 1607 of 2012.


50. Although Colombia’s oil company, Ecopetrol, had targeted 819,000 barrels per day in 2014, the mid-year estimate put production at a considerably lower 770,000. “Oil Majors Lodge Bids for Colombia Exploration Rights,” Financial Times, July 24, 2014.


63. “Reforma tributaria.”


65. “Reforma tributaria.”


70. “Colombian Unemployment Lowest in 12 years, Rural Unemployment Still High,” Colombia Reports, November 1, 2013.

71. It remained at CO$4 x 1000 for the 2015–18 period and phasing out at CO$3 x 1000 in 2019, CO$2 x 1000 in 2020, CO$1 x1000 in 2021, and no tax by 2022.
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