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PRESIDENTS AND ECONOMIC POLICY-MAKING:

THE POLITICS OF TAX REFORM IN BOLIVIA AND ECUADOR

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Abstract

This comparative study of Ecuador and Bolivia analyses the political dynamics of economic reforms in the last two decades. The question guiding this work is: *under which conditions are presidents able to introduce the reforms they propose?* and the focus is put on the political processes behind the tax reforms that were implemented and those that failed. The theoretical framework employs an institutionalist approach and focuses on how variations in institutional structures have shaped policy-making processes. Since most authors limit their analysis to institutional aspects, the thesis aims to make a contribution to this approach by analysing the influence of particular institutional aspects on the introduction of reforms. Other variables, such as the influence of private sector groups or popular protest, are included in the analysis to explore to what extent they challenge or complement the argument. The tax reforms of the last two decades are used as a case study to account for dynamics of economic policy-making in the two countries more generally. The study resulted in three main findings. Firstly, the institutional analysis proposed provides a coherent explanation as to why Bolivia was able to implement wide-ranging tax reforms during the 1980s and 1990s while presidents in Ecuador usually failed to introduce similar changes. Bolivia's particular form of presidentialism – featuring a parliamentary element of electing the president in Congress in the second round of elections – has produced coalition governments after 1985, which allowed presidents to introduce wide-ranging tax reforms. In Ecuador, on the other hand, tax reforms often failed due to the lack of institutional incentives for overcoming the political deadlock of a fragmented Congress. A second finding contributes to the *economic crisis approach* as hyperinflation proved to have an impact on the policy-making process (Bolivia after 1985), which has not necessarily been the case when countries experienced other types of economic crises (e.g. Ecuador in 1999). Thirdly, the change in the pattern of policy-making within Bolivia is examined. It is argued that the extra-institutional processes Bolivia experienced during the recent years have been caused by the same institutional mechanism that had brought political stability during the 1980s and 1990s as *coalition politics* was dependent on patronage payments and the political parties lost more and more support. This thesis, in short, fills a gap by connecting institutional analysis to actual economic reforms; it establishes a link between political structures and their effect on policy-making as regards the case of tax reform.

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Acronyms and Abbreviations

(Political parties in italics)

General

CAF	Corporación Andina de Fomento
CET	Common External Tariff
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
FT	Financial Times
FTT	Financial Transactions Tax
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
IDB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
PDBA	Political Database of the Americas
SOE	State-owned Enterprise
VAT	Value-added Tax
WDI	World Development Indicators

Ecuador

APRE	*Acción Popular Revolucionario Ecuatoriano*
BCE	Banco Central del Ecuador
CFP	*Concentración de Fuerzas Populares*
CMS	Coordinadora de Movimientos Sociales
CONAIE	Confederación de Nacionalidades Indígenas
CORDES	Corporación de Estudios para el Desarollo
CORPEI	Corporación de Promoción de Exportaciones e Inversiones
CTE	Confederación de Trabajadores
DP	*Democracia Popular*
ECS	Sucre
FA	*Frente Amplio*
FADI	*Frente Amplio de Izquierda*
FLACSO	Facultad Latinoamericana de Ciencias Sociales
FRA	*Frente Radical Alfarista*
FUT	Frente Unitario de Trabajadores
ID	*Izquierda Democrática*
IESS	Instituto Ecuatoriano de Seguro Social
INEC	Instituto Nacional de Estadística y Censos
LP	*Liberación Provincial*
MIN	*Movimiento Independiente Nacional*
MCNP	*Movimiento Ciudadanos Nuevo País*
MPD	*Movimiento Popular Democrático*
MUPP-NP	*Movimiento Pachakutik - Nuevo País*
OCP	Oleoducto de Crudos Pesados
PC(E)	*Partido Conservador (Ecuatoriano)*
PD	*Partido Demócrata*
PLN	*Partido Libertad Nacional*
PLR	*Partido Liberal Radical*

PRE	*Partido Roldosista Ecuatoriana*
PS(E)	*Partido Socialista (Ecuatoriano)*
PSC	*Partido Social Cristiano*
PSP	*Partido Sociedad Patriótica 21 de Enero*
PUR	*Partido Unión Republicana*
RO-(S)	Registro Oficial-(Suplemento)
SRI	Servicio de Rentas Internas
TC	Tribunal Constitucional
TSE	Tribunal Supremo Electoral
UNE	Unión Nacional de Educadores

Bolivia

ADEPI	Asociación Departamental de la Pequeña Industria de La Paz
ADN	*Acción Democrática Nacionalista*
AP	*Acuerdo Patriótico (ADN and MIR)*
ARBOL	*Alianza de Renovación Boliviana*
ASOBAN	Asociación de Bancos Privados
BOB	Boliviano
CABOCO	Cámara Boliviana de la Construcción
CADEX	Cámara Departamental de Exportadores
CAINCO	Cámara de Industria, Comercio, Servicios y Turismo
CEPB	Confederación de Empresarios Privados de Bolivia
CNE	Corte Nacional Electoral
CNC	Cámara Nacional de Comercio
CNI	Cámara Nacional de Industrias
COB	Central Obrera Boliviana
CONDEPA	*Conciencia de Patria*
CONFIP	Comité de Normas Financieras Prudenciales
CSUTCB	Confederación Sindical Única de Trabajadores Campesinos de Bolivia
DGII	Dirección General de Impuestos Internos
EJE	*Eje (Pachakutik)*
FEBOPI	Federación Boliviana de la Pequeña Industria
FEPLP	Federación de Empresarios Privados de La Paz
FSB	*Falange Socialista Boliviano*
GES	Grupo Especial de Seguridad
IU	*Izquierda Unida*
INE	*Instituto Nacional de Estadística*
MAS	*Movimiento al Socialismo*
MBL	*Movimiento Bolivia Libre*
MIP	*Movimiento Indígena Pachakuti*
MIR	*Movimiento de Izquierda Revolucionaria*
MNR	*Movimiento Nacionalista Revolucionario*
MNRI	*Movimiento Nacionalista Revolucionario de Izquierda*
MNRV	*Movimiento Nacionalista Revolucionario – Vanguardia*
MPP	*Movimiento Popular Patriótico*
MRTKL	*Movimiento Revolucionario Tupac Katari de Liberación*
NFR	*Nueva Fuerza Republicana*
NEP	New Economic Policy
NPE	Nueva Política Económica
PDC	*Partido Demócrata Cristiano*

Ps	Pesos
PS	*Partido Socialista*
PS-1	*Partido Socialista Uno*
RAL	Requerimiento de Activos Líquidos
RC-IVA	Régimen Complementario al Impuesto al Valor Agregado
SIN	Servicio de Impuestos Nacionales
SNII	Servicio Nacional de Impuestos Internos
UCS	*Unión Cívica Solidaridad*
UDAPE	Unidad de Análisis de Políticas Sociales y Económicas
UDP	*Unión Democrática Popular*
UN	*Unión Nacional*
VSB	*Vanguardia Socialista Boliviana*
YPFB	Yacimientos Petrolíferos Fiscales de Bolivia

1 Introduction

"Economists may have dominated the academic discussion of taxation, but political criteria appear to have dominated tax policy-making in the real world."
B. Guy Peters[1]

During the last two decades almost all Latin American countries have undergone a U-turn in their development strategy and have increasingly implemented market-oriented economic policies. In Duncan Green's words this phenomenon can be described as a "silent revolution" (Green, 1995). While this paradigm-shift has taken place region wide, there are, however, great variations in timing, scope and content of so-called structural adjustment and stabilisation policies. Chile, for instance, has introduced wide-ranging economic reforms[2] throughout the last two decades and now has one of the most open economies of the region. Brazil, in contrast, has been a late reformer as it implemented heterodox programmes during the 1980s and only turned towards more orthodox economic policies in the mid-1990s. Why did some countries implement wide-ranging market-oriented reforms, while others did not? Why did countries introduce economic reforms for certain periods and not at other times?

Parallel to economic liberalisation Latin American countries have experienced a process of democratisation and it was once commonly assumed that these two processes would be naturally reinforcing each other and would eventually lead to consolidated democracies and market-oriented economies. Events of recent years have challenged this assumption. Economic liberalisation is increasingly criticised, in some cases reversed and political instability has put democratic viability into question. The recent events in Bolivia and Ecuador and the early termination of Lucio Gutierrez's and Carlos Mesa's presidential terms provide striking examples.

[1] Peters, 1991:55.
[2] When using the term "reform" I will follow Grindle's definition: "a deliberate effort on the part of the government to redress perceived errors in prior and existing policy and institutional arrangements" (Grindle, 1991:4). This should not be considered to imply a judgment on the quality of the policies.

1.1 RESEARCH QUESTION

In this comparative study of Ecuador and Bolivia the political dynamics of economic reforms is being analysed. The question guiding this work is: *under which conditions are presidents able to introduce the reforms they propose?* Comparing the patterns of economic reforms of Ecuador and Bolivia for most of the last two decades, the differences seem rather striking: Bolivia undertook a "shock" adjustment with its *Nueva Política Económica* (New Economic Policy – NPE) in 1985 and has introduced wide-ranging policies in the subsequent years and throughout the 1990s. During the same period the country has also experienced a period of great political stability. Ecuador on the other hand took a gradual approach to implementing reforms ever since its return to democracy (1979). Grindle (1993) termed this pattern as *"muddling through"*, while Edwards (1995:7) classified Ecuador even as a *"non-reformer"*. Considering these patterns – how can the differences between Ecuador and Bolivia be accounted for? While there is a stark contrast between their policy-making processes in the 1980s and 1990s, the countries have become more similar during the last couple of years as Bolivian presidents struggled to have their economic reforms approved and as the country lapsed into political instability, as expressed in the overthrow of Sánchez de Lozada in October 2003 and the resignation of President Mesa in June 2005. What has caused these changes within Bolivia?

These questions provide the background for the research undertaken and an explanation for these processes will be sought.

1.2 THEORETICAL APPROACH AND ARGUMENT

The theoretical framework employed in this study has a neo-institutionalist approach as its base. The main argument therefore focuses on how the different political structures of the two countries have shaped the processes through which policy decisions have been made and implemented.

Empirical Institutionalism. A stream of new institutionalism, which B. Guy Peters (1999:78ff) termed "empirical institutionalism", has focused on analysing how the structure of governments leads to differences in policy processes and the choices made by governments. Most of all, this literature compares the functioning of presidential systems to that of parliamentary systems. A debate about the relative advantages or disadvantages of either system was triggered by Juan Linz's article *Presidentialism or Parliamentary*

Democracy: Does It Make a Difference?.[3] He essentially argued that a democratic regime is more likely to be consolidated when it has a parliamentary system and that presidentialism causes problems of governance (Linz, 1994). More often than not the discussion that has evolved focused on the dichotomy between a parliamentary and a presidential system; on broad regime type rather than on specific variations between presidential regimes or differences of institutional features. A lot of research along this line has involved large statistical studies – like a recent work by Przeworski et al. (2000) – rather than smaller case studies. The main question behind most analyses was whether it is parliamentary or presidential regimes that lead to stability and democratic consolidation. A consensus quickly emerged: the majority of scholars agreed on the superiority of parliamentarism, or, as Jorge Lanzaro put it, on the "satanisation of presidentialism" (Lanzaro, 2001b:18).

Some analysts, however, have questioned the primacy accorded to parliamentary regimes and have focused on the specific design of presidential regimes and the differences between them. Mainwaring and Shugart (1997a) convincingly questioned the pro-parliamentary analysts, for example, by referring to a crucial flaw in the analysis: selection bias. Since most presidential regimes can be found in Latin America and most parliamentary ones in Europe or the former British colonies, it is difficult to determine to what extent the instability and failure of governance in Latin America has been caused by the regime type or due to economic and other factors. It is difficult to say whether the European-style parliamentary systems would have fared much better facing the economic crises occurring in Latin America during the 1980s and 1990s. Mainwaring and Shugart (1997a) examined the variations between presidential regimes in different countries and how specific institutional designs affect political processes and democratic stability. Central to their analysis were presidents' constitutional powers and the nature of the parties and the party system. They argued that there is no *"universally best form of government"* (Mainwaring and Shugart, 1997:3) and that a presidential regime may potentially be the more adequate form of government for some countries. The question of how to produce effective governance, rather than *being about* presidentialism or parliamentarism, *is what* kind of balance there is between a president's constitutional and partisan powers. In their detailed

[3] A paper version of his arguments appeared in 1987; a summary was published in 1990 in the *Journal of Democracy (No. 1, 51-69)*; and the ultimate version came out in 1994, which was faithful to the original but extended by comments on the preceding discussion of his arguments (Linz, 1994).

analysis Shugart and Carey (1992) also questioned the superiority of parliamentarism and identified potential strengths and merits of presidential regimes. They pointed out different forms of creating a balance between presidents and assemblies, which in their view, is a crucial condition for effective governance. More concretely, they argued that "efficient presidentialism" goes together with weak presidencies. Weak presidential regimes, in turn, are characterised by a combination of limited constitutional powers of presidents and a prominent role of assemblies in the legislative process. Shugart and Carey argued that this combination reduces conflicts between the executive and the legislature and leads in consequence to an efficient political regime.

The analysis of those scholars based within "empirical institutionalism" has usually been limited to constitutional structures of types of governments and has been disconnected from what political systems actually do, i.e. they have often left aside the aspect of policy-making. As George Philip pointed out: *"The literature has, too often, offered up either institutions without policy change (via Douglass North) or policy without institutional variances (via the public choice theorists)."* (Philip, 1998:97). A number of authors, however, differ from this approach and did actually connect the analysis of institutional aspects to that of policies. Weaver and Rockman (1993), for example, analysed how a set of different institutional aspects has an impact on the capacity of governments to function effectively. In a series of case studies on different policy areas their institutional framework was applied to the US presidential and a number of parliamentary systems. A shortcoming of this work is, however, its one-sided perspective. By comparing a single presidential regime to various parliamentary ones to show that not all parliamentary regimes function in the same way, the dimension of differences between presidential regimes is left out. A study of presidentialist regimes and the effect of institutional aspects on the policy-making process was carried out by Haggard and McCubbins (2001) as they addressed policy areas such as budgeting, privatisation and electricity regulation. This study follows the aforementioned authors in focusing on institutional detail rather than broad regime type and the interrelatedness of institutional features and economic policies. The thesis aims to make a contribution to this approach by analysing how variations in institutional structures influence the possibility of presidents to introduce economic reforms. Other theoretical approaches commonly used for explaining economic policy-making processes – focusing on the influence of interest groups or external actors – are challenged in this study. It is argued that the importance of interest group pressure or external influence is overstated and that particular institutional aspects better explain patterns of economic reforms. The argument why these alternative approaches are insufficient for explaining the different patterns of tax policy-making is made in the conclusion of the thesis (see Chapter 8.2). The approach used here differs from other institutional frameworks such as rational choice institutionalism. The rational choice branch of institutionalism tries to offer a neat and elegant theory by considering formal rules only, and thereby fails to adequately reflect the complex dynamics of Latin American politics. When using a small number of cases and looking at political processes in detail, any endeavour to use a mono-causal explanation becomes futile. Though the resulting explanations might be less neat than those of rational choice institutionalism, they are most probably closer to reality (see also Weyland, 2002b). Therefore, while institutional aspects will be central, other variables – such as the influence of private sector groups, popular protest or the use of patronage payments – are included in the analysis to find out to what extent they challenge or complement the argument set out here.

Literature on Ecuador and Bolivia. Very few authors deal specifically with the countries studied and relate an institutionalist perspective to governability. ***Ecuador.*** In the case of Ecuador, Grindle and Thoumi (1993) analysed the adjustment policies introduced by Ecuadorian governments between 1982 and 1990. They distinguished between introducing reforms and the technocratic style employed, and sustaining reforms at which stage the authors considered the opposition of economic interest groups and political parties. Grindle and Thoumi revealed a pattern of "muddling through" consisting of a successful introduction of policy reforms which were subsequently watered down or reversed due to political and economic pressure. While the concept of muddling through describes Ecuadorian patterns well, the analysis does not account for the fact that reforms frequently did not pass due to presidents' lack of support in Congress. In her analysis of Ecuador's presidential system, Conaghan (1994a) argued that Ecuadorian presidents usually lack partisan support for their policies in Congress due to the institutional arrangements and the multi-party system. Given that presidents were unable to form majorities, attempting to bypass the Congress when introducing policies became an often chosen strategy. Developing some of these ideas further, Conaghan (1995) set out in detail the processes of party proliferation, electoral volatility, and how parties are marginalised from policy-making. Describing the party system she stressed the following characteristics: executive-legislative conflicts were related to the existence of an extreme multi-party system; policy decisions were dominated by technocrats chosen by presidents and parties were largely excluded from the process; finally, the Ecuadorian voters' party preferences were very volatile and differed considerably from one election to the next. Conaghan's work is crucial for an understanding of Ecuador's political system, yet her focus on technocrats is unable to explain why policy proposals – as elaborated by technocrats – often failed to be introduced.

The authors Salgado and Santos (1998) provided a detailed analysis of Ecuador's fiscal system and the reforms introduced in this area. While the work claimed that failure to raise revenues leads to political tensions and difficulties in governing, it lacks a perspective on the political dynamics of the policy-making process and does not explain why fiscal policies failed. In their study on presidentialism and parties in Ecuador between 1979 and 1997 Burbano and Rowland (1998) focused on executive-legislative interactions. They tried to explain Ecuador's institutional and governability crisis by referring to the variables of the presidential system and institutional arrangements concerning the executive and the legislature, the party system, and political culture. Finally, Mejía-Acosta's work (2002) represents not only a recent but also very comprehensive analysis of Ecuador's political system. Considering the time period 1978 to 1998, he provided a lot of empirical detail on the functioning of the electoral system, the party system and executive-legislative relations. He concluded that the governability problem of the country was caused by an interaction between the institutional arrangements and the strategies adopted by the political actors. While the last two studies provide detailed information about institutional aspects concerning party interactions and their relations to the presidents, neither of them makes a connection to policies introduced by the different governments.

Bolivia. The work of Gamarra has been crucial in the analysis of Bolivia's form of presidentialism, the party system and coalition politics. He developed the term "hybrid presidentialism" (1992) to define the country's political system and showed how it may be a model for other Latin American regimes in its ability to solve problems of dual legitimacy. Pointing to the relation between the method of electing the president and policy-making, he maintained that the system's ability to produce coalitions – also facilitated by the leadership skills of those involved – was vital for the introduction of economic reforms since 1985

(Gamarra, 1994). Yet Gamarra also continually stressed the drawbacks of coalition politics and the party system: parties in Bolivia were not so much driven by ideologies but rather by their desire to access patronage. According to Gamarra, the circulation of public sector positions had come to play a crucial role in the formation of coalitions (see particularly Gamarra & Malloy, 1995). He continued to be concerned with both the advantages and the disadvantages of the Bolivian system: he argued that hybrid presidentialism managed to pursue democratisation while at the same time introducing wide-ranging economic reforms. He also emphasised that coalitions worked while sufficient resources existed; now that patronage demands had grown, coalitions were destabilised (Gamarra, 1997). While in the majority of his work Gamarra focused on an analysis of political structures and referred to policies only broadly, he considered economic reforms in detail in a study of 1998. The analysis is mainly limited to the government of Sánchez de Lozada (1993-97), however (Gamarra, 1998). In a recent work (Gamarra, 2003) he analysed the influence of historical factors on the party system and took into account the current political crisis of Bolivia. His explanation maintained that parties have lost links and have proved unable to represent civil society, in consequence to which social movements and organisations have become political actors and successfully influenced political decisions in certain areas.

Mayorga's work bears some similarity to that of Gamarra. Using the concept of "parliamentarised presidentialism" Mayorga (1997) outlined the parliamentary features of Bolivia's form of presidentialism such as the election of presidents by Congress in case of a second round as defined by Article 90 of the Constitution. The politics of coalition resulting from this institutional mechanism was crucial to democratic consolidation, Mayorga maintained. Describing the four inter-party governments since 1985 Mayorga (2001) extended his arguments, claiming that Bolivia's experience showed how the difficulties caused by divided government marking most Latin American regimes could be solved. While also evaluating the process of democratic consolidation in a recent study (Mayorga, 2002), he went on to complement his analysis by examining the regressive process by which political parties and their leaders were increasingly discredited and "antisystemic" social actors began to influence Bolivian politics (Mayorga, 2002). Domingo (2001) developed the analysis of the disadvantages of coalition politics further. Providing an analysis of the party system, the effects of electoral reforms and the dynamics of coalition politics, she argued that coalition politics was possible due to the underlying politics of patronage, the autocratic style of the executive and technocrats to impose policies from above, and finally due to the consensus on neoliberal reforms among those in decision-making positions. While coalitions had helped governability, Domingo concluded, they had led to a serious problem of representation as parties failed to fulfil their role as mediators between state and society.

While Gamarra, Mayorga and Domingo mainly considered institutional aspects, the work of Morales, the current President of Bolivia's Central Bank, emphasised the policy side. Morales has written extensively on the political economy of economic reforms and issues of economic stabilisation with a main focus on the New Economic Policy (NEP) introduced in 1985 (Morales, 1991; 1994; 1996; 2001). While he refers to some political aspects of adjustment, an economic analysis is at the centre of his work. Among those who do connect an institutional analysis to economic policies is a recent study of Grindle (2003) in which she gave a broad overview of policies introduced between 1985 and 2002. Her main interest lies in the role of the MNR as the majority of significant reforms were introduced while this party was in power.

As in the wider field of empirical institutionalism, the above mentioned authors focused mainly on institutional aspects in isolation; they paid little attention to actual policy changes. The contribution of this thesis is therefore to look at how the introduction of economic reforms was influenced by particular institutional arrangements. A large number of the existing studies on these countries also relates to a different time-frame than the one taken here. In the case of Bolivia, for example, a significant amount of research was done on the introduction of the New Economic Policy but less so on other time periods. The thesis extends this time-frame by including governments and their economic policies of the last two decades.

Research on these countries generally uses *either* Ecuador *or* Bolivia as a case study. Malloy's *El problema de la gobernabilidad en Bolivia, Perú y Ecuador* (1992) represents one of the few comparative studies. Referring to the governments of Belaúnde in Peru (1980-85), Febres Cordero in Ecuador (1984-88) and Paz Estenssoro in Bolivia (1985-89) he concluded that the leadership skills of the latter must have played a crucial role given that only in Bolivia economic reforms were successfully introduced despite similar institutional legacies and implementation strategies in all three countries. Though Malloy called this study comparative he mainly outlined the experience of Bolivia and failed to explain why and how exactly the Ecuadorian and Peruvian presidents were unsuccessful (see Malloy, 1991). Truly cross-country comparative is, however, Conaghan and Malloy's *Unsettling Statecraft: Democracy and Neoliberalism in the Central Andes* (1994). In this rare intra-Andean study, the authors compared the democratic transitions and neoliberal economic reforms during the 1980s in Ecuador, Peru and Bolivia. Conaghan and Malloy looked at the role of economic interest groups and the political management of individual policy-makers to account for the different patterns of economic reforms in the three countries. Given its comparative perspective and its analysis of the political dynamics of economic policy-making, this study probably comes closest to the one undertaken here. The approach and explanatory framework employed in this thesis differs, however: while Conaghan and Malloy consider the business sector as a crucial actor to account for policy choices, this view is questioned here (see Chapter 8.2). In the empirical analysis it will become clear that the influence of the private sector is often overstated and that it is rather specific institutional arrangements that can explain policy-making processes. Another difference is that the time-frame of this study are the last two decades while *Unsettling Statecraft* looked at the 1980s only.

In summary, this thesis will go beyond the existing studies mentioned by evaluating the effects of particular institutions on policy-making processes, by applying a time-frame of the last two decades, and by providing a comparative perspective.

1.3 Selection of Tax Reform as Case Study

Tax reform has been chosen as the main case study for various reasons. Having briefly analysed economic policies across the whole spectrum of so-called *Washington Consensus* reforms, it became obvious that the area of tax reform provides a representative case for the economic reform process in Ecuador and Bolivia. It is assumed that – while focusing on one particular area of economic reform – the analysis will provide insights into the political dynamics of policy-making more generally.

Studying tax reform from a political science perspective seems worthwhile as tax policies are usually analysed on a purely technical basis; it has traditionally been the realm of economists. More recently, however, some political scientists have taken interest in the field of tax reform, with B. Guy Peters (1991) and Sven Steinmo (1998) most prominent among those. Both of them argued that the way governments raise the money they need for governing is an essentially political question. In addition, no matter how carefully designed by economists, the fate of tax reform proposals usually depends on political processes. While Steinmo and Peters focused on industrialised countries in their work, hardly any literature – taking a political science perspective – exists of tax reform in developing countries. Kent Eaton (2002) provided an important exception with his comparative study on tax reform in Argentina and the Philippines in which he focused on the influence of the legislature on tax policy-making. As regards Latin America, he argued, fiscal policy is important for the way it represents a break from the past development model of import-substituting industrialisation. In the pre-liberalisation period, Latin American economies were often marked by high budget deficits and fiscal instability; tax systems were complex, relied heavily on excise taxes and taxes were generally widely evaded. This failure to raise sufficient revenue domestically was mainly covered by external loans or money creation. The design and functioning (or rather lack thereof) of the tax systems throughout most of Latin America, thus had a major influence in the debt crisis the region was to experience in the 1980s and 1990s. Given that recourse to foreign borrowing as a means to balancing fiscal deficits was basically ruled out, most countries of the region started implementing tax reforms at some point during the 1980s or 1990s. Timing, scope, and content of the reforms to the tax systems, however, varied widely.[4]

With respect to the cases of Ecuador and Bolivia, no studies on the tax reforms of the last two decades exist. This thesis aims at making a contribution by analysing this area of economic policies. Tax reform has thus been chosen as the case study for the following reasons: a) it appears representative for patterns of economic policy-making in Ecuador and Bolivia more generally; b) tax reform is an area rather neglected by political scientists; c) fiscal policies have played an important role – both economically and politically – before and after the shift to market-oriented economies; d) no literature on the experiences of tax reform exists on Ecuador and Bolivia for the time period of the last twenty years.

[4] For an overview of tax reforms in Latin America see, for example: Shome (1992;1999); Perry and Herrera (1994); Bird (1992); Bird and Oldman (1990); Bird and Perry (1994); IBRD (1991); Gillis (1989).

In the analysis of tax reforms the focus here is put on internal taxes, especially the Value-added Tax (VAT), income and excise taxes; changes of other internal taxes are taken into account when they played a role in the discussion of a particular reform. The focus on internal taxes was chosen in order to scale down the number of cases to be analysed but also because policy changes as regards other taxes have their own dynamics. External taxes, or tariffs, for example, have been subject to change given agreements within the Andean Pact and have thus been less a matter of domestic politics than internal taxation. Taxation of the hydrocarbons sector is the other main field displaying its own dynamics. While left aside here, this area would be well worth analysing in some future research. Administrative changes, including those regarding the status and structure of the Internal Revenue Services, are taken into account yet are of secondary importance to internal taxes for the purposes of this study.

1.4 Tax Reform in Latin America

To put the tax reform experiences of Ecuador and Bolivia into context, the overall trends occurring in Latin America during the 1980s and 1990s shall be outlined here. Following the debt crisis of 1982 most countries of the region saw their capital inflows sharply reduced and in consequence needed to either cut spending or increase tax revenues. Reforms to the tax system were introduced in most of Latin America during this period. Though they differed regarding their timing and scope, they followed a general trend. The most important changes included a greater simplification of the tax system, the reduction of tariffs, the increased importance of Value-added Tax (VAT), a decline in the progressivity of income taxes, and attempts to improve the efficiency of tax administration.

Decline in Tariffs. One of the major elements of the so-called Washington Consensus reforms introduced in the region since the 1980s was trade liberalisation. While the previous economic model of import substitution industrialisation had relied heavily on taxes on foreign trade, governments throughout the region started to significantly reduce and gradually abandon import tariffs. At the same time taxes on exports all but disappeared in Latin America. As a result of these changes revenues went down: for example, in Argentina taxes on international trade collected 1.8 per cent of GDP in 1985-89 and only 0.8 per cent in 1995-98, in Colombia it went from 2.2 to 1.0 per cent during the same time period (Tanzi, 2003:338). Trade duties in Latin America had generated around 20 per cent of total tax revenues in the mid-1970s and halved to around 10 per cent by 1998 (Mahon, 2004:7). Both Bolivia and Ecuador complied with this trend as tariff revenues in Bolivia fell from representing around 40 per cent of total tax revenues in 1980 to around 10 per cent during 1991-95 (on average); in Ecuador this share declined from around 33 per cent to 24 per cent in the same time period (Lora, 1997:6). Since tariffs had previously thus provided significant revenues in the region, these had to be sought elsewhere and the importance of taxes on consumption increased.

Value-added Tax. Along with the decline in tariffs came the introduction or expansion of VAT, which replaced turnover or sales taxes in most countries of the region during the last twenty years. While some countries, such as Argentina, Brazil, Colombia and Nicaragua introduced multiple rates, the majority of countries introduced a single rate of VAT. Standard rates have also gone up over time – as the importance of VAT increased tax systems centred more and more around taxes on consumption. Chile, Paraguay and Peru represent an exception to this trend as VAT rates were either lowered or remained the same (Shome, 1999:13). As of July 2000 the unweighted average of VAT rates in Latin America was 15.17 per cent (Tanzi, 2003:340). Bolivia, therefore, with its rate of 14.92 per cent[5] comes very close to the average, while Ecuador's 12 per cent rate is significantly below it. Due to this increase in the rates – and probably also because tax administrations became more efficient – revenues from the VAT grew significantly. As Mahon reported, while taxes on goods and services accounted for around 25 per cent of total tax revenues in the mid-1970s it went up to 43 per cent by 1998 (Mahon, 2004:6-7). Argentina, for example, tripled its VAT income and together with Brazil and Chile now collects similar revenue levels to those of OECD countries from this tax (Tanzi, 2003:342). Revenues, however, vary widely as Panama's VAT, for example, collected 1.9 per cent of GDP while Brazil's collected 9.5 (in 1996) (Shome, 1999:13). Bolivia's VAT revenues of 4.5 per cent of GDP lie in the middle of this range, while Ecuador collected 3.3 per cent of GDP with only Mexico and Panama generating less than this (in 1996; Shome, 1999:14).[6] To take into account the different rates applied in different countries when considering VAT-GDP ratios, the concept of VAT productivity is often used. It is defined as VAT revenue as a

[5] The legislated tax-inclusive rate is 13 per cent. The VAT is incorporated in the price of the product, so the effective VAT rate is 14.92 per cent of the price excluding the tax itself.
[6] It has to be taken into account, however, that Bolivia had an effective VAT rate of 14.92 at that time, while Ecuador's was 10 per cent.

percentage of GDP divided by the VAT rate. Taking this aspect into account VAT productivity in 1995 was rather low in Colombia, Nicaragua, Mexico and Argentina (around 0.2 per cent), Honduras, Costa Rica, El Salvador, and Chile have a high productivity (around 0.5), and Ecuador and Bolivia were in the middle (0.35 and 0.4 respectively) (Lora, 1997:6).

Income Taxes. As tax systems shifted more and more emphasis to indirect taxes, the role of income taxes declined, thereby reducing progressivity. As Tanzi (2003:345) showed income tax rates have fallen during the last two decades: the top personal income tax rate in Latin America went from an average of 49.6 per cent in 1985-86 to 27.8 per cent in 1999-2000; meanwhile the rate of the corporate income tax went from 43.3 per cent in 1986 to 28.6 per cent in 1999-2000. The personal income tax rate dropped almost by half and in 2000 only Chile and Mexico had a rate higher than 40 per cent, with all other countries charging 30 per cent or less (Tanzi, 2003:345). Corporate income taxes were also lowered though not to the same extent as personal income taxes. Parallel to this decline in rates, the personal exemption levels went up so that less and less people fall into the tax brackets and therefore do not pay any income tax. While the regional average of the personal exemption level was 0.47 as share of per capita GDP in 1986, it increased to 1.36 in 1997 (Shome, 1999:7). According to the same data Bolivia's personal exemption level fell during this time period, while Ecuador's increased. In 2001 revenues from income taxes represented less than 5 per cent of GDP compared to 12.5 per cent in OECD countries (Singh et al., 2005:31). A few countries, however, managed to increase their share of income tax revenues during the last two decades, as did Argentina, Brazil, Bolivia, and Peru (Tanzi, 2003:346) yet the general trend was that revenues from taxes on income, profits and capital gains slightly declined (Mahon, 2004:7).

Other taxes. While the changes regarding the taxes mentioned above represent the major trends in taxation in Latin America during the last twenty years, other taxes have also been introduced or experimented with in various countries of the region. A *Gross Assets Tax* was established in Mexico, Argentina, Costa Rica, Guatemala, and Venezuela. Usually charged at 1 to 2 per cent of the gross assets of enterprises, it serves as a way to ensure that companies pay at least a minimum tax and prevents them from fully avoiding tax contributions (Tanzi, 2003:347-8). Bolivia's tax system never featured this tax and in

Ecuador a gross assets tax was charged as a one-off tax of 1 per cent in 1999 only. There was a general trend towards lower taxation of capital as fewer and fewer countries employed taxes on assets or net worth during the 1990s than compared to the 1980s. A *Financial Transactions Tax* (FTT) was introduced in several countries in order to raise revenues. A tax on financial transactions was or in some cases still is levied in Argentina (introduced in 1983, 1988 and 2001), Bolivia (2004), Brazil (1994 and 1997), Colombia (1998), Ecuador (1999), Peru (1989), and Venezuela (1994 and 1998). Often this tax was resorted to when the country experienced an economic crisis (e.g. Ecuador in 1999 or Venezuela in 1994 and 1999). Generally, a financial transactions tax was chosen to generate revenues in a relatively short time period and because it was politically much less controversial than other taxes (an aspect which played an important role when introduced in Bolivia in 2004). As regards revenues the more recent experiences of this tax were more positive than in the cases where it was introduced earlier. Particularly Brazil, Colombia and Ecuador gained significant revenues from their FTT. In Ecuador, for example, the 1 per cent tax on financial transactions produced revenues of 3.5 per cent of GDP in 1999 (Coelho et al., 2001:12). A third example of experiments in the tax systems are the various forms of *simplified tax regimes* widely introduced in Latin America. To find adequate forms of charging the informal sectors, a large number of countries developed simplified forms of taxation for small taxpayers. Furthest in this development are Argentina, Brazil, Bolivia and Peru, which created a single tax rate to be paid by the informal sectors instead of the major taxes such as VAT, income taxes, and social security taxes (Tanzi, 2003:350).

Tax administration. Finally, significant efforts were made throughout the region to improve the effectiveness of tax administrations.[7] Often this involved: a restructuring of administrative units, changes were made regarding their personnel, tax agency – taxpayer relations were modified, administrative processes were increasingly computerised and certain tax administration activities were privatised (usually by giving banks a greater role in tax collection). In Ecuador, the reform of tax administration starting in 1997 led to a significant increase in revenues as VAT collections, for example, rose from 3.5 per cent of GDP (on average) in 1993-97 to 6.8 per cent in 2000 (IMF, 2003:64; see also Chapter 6.5).

[7] For a good overview of tax administration reforms during the 1980s see Bird and Casanegra (1992).

Revenues. Tax revenues have increased significantly during the last twenty years in most countries of the region. As Table 1.2 shows revenues have gone up particularly in Argentina, Bolivia, and Brazil. In Argentina, for example, the tax-GDP rate went from 10 per cent in 1985 to 17.6 per cent in 1999 and in Brazil from 6.4 to 15.0 per cent in the same years. In most other countries revenues also increased with the exceptions of Chile were they remained stagnant at a high level, in Costa Rica they slightly declined during the 1990s, and remained stagnant in Mexico, Uruguay and Peru. Bolivia went from having rather low levels of tax collection to having one of the highest rates in the region: from 7.9 per cent of GDP in 1985 to 18.1 per cent in 1999. Ecuador, by contrast, increased its revenues from 6.4 in 1985 to 9.8 in 1999 only (Tanzi, 2003:332), though they increased significantly after that partly due to the improved tax administration. Depending on the tax-GDP ratio Shome (1999) divided Latin America into high tax, medium tax, and low tax groups (see Table 1.1).[8]

Table 1.1: High-, Medium-, and Low-Tax Countries, Latin America

High-Tax (> 20% of GDP)	**Medium-Tax** (11-20% of GDP)	**Low-Tax** (< 10% of GDP)
Brazil	Argentina	Ecuador
Chile	Bolivia	Guatemala
Costa Rica	Colombia	Paraguay
Nicaragua	Mexico	Peru
Uruguay	Panama	Venezuela

Source: Shome, 1999:14. Own elaboration.

[8] Categorised according to data from 1992 and 1996. Note that this categorisation is based on general government revenue. If this was higher than 20 per cent of GDP, countries are in the high-tax group; in the low-tax group if general government revenue (and central government revenue in the case of countries highly dependent on petroleum revenue) was 10 per cent or less; and in the medium-tax group if revenue was between 11 and 20 per cent (Shome, 1999:15).

Table 1.2 Total Tax Revenues of the Central Governments (as percentage of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Argentina	9.1	12.0	10.1	9.1	8.4	10.0	9.5	9.4	7.2	9.6	12.4	14.2	16.5	17.9	17.7	17.3	16.0	17.3	17.6	17.6
Bolivia	8.5	9.2	4.9	2.9	2.1	7.9	7.9	8.1	8.4	7.9	8.2	8.7	10.7	11.4	12.4	12.4	12.3	14.5	16.3	18.1
Brazil	7.7	7.6	7.5	8.0	6.6	6.4	6.5	6.0	6.0	5.7	10.2	10.0	9.4	10.6	13.2	12.6	11.8	12.6	14.5	15.0
Chile	17.4	19.2	18.3	17.7	19.6	19.1	18.4	18.1	15.5	15.1	14.5	16.7	17.3	18.0	17.5	17.0	18.2	17.6	17.8	16.9
Colombia	7.6	7.2	7.3	6.7	6.8	8.6	9.0	9.5	9.4	9.3	9.3	10.7	11.2	11.6	11.8	11.4	11.5	12.2	10.5	10.8
Costa Rica	11.2	12.0	12.5	15.6	15.3	15.2	13.8	14.5	14.4	14.4	14.0	11.4	12.0	12.1	11.7	12.5	12.7	12.6	12.8	12.5
Dom. Republic	10.3	9.7	8.0	8.5	9.0	9.7	11.3	11.4	11.8	12.5	10.5	11.8	13.8	14.8	14.0	13.8	13.1	14.7	15.0	14.4
Ecuador	7.1	6.6	5.6	5.4	5.9	6.4	8.1	7.9	7.5	8.0	7.6	7.6	7.2	7.4	7.7	8.0	7.2	9.3	9.9	9.8
El Salvador	11.1	11.4	10.6	10.6	11.6	11.6	13.1	10.9	9.3	7.6	9.1	9.5	9.6	10.3	10.9	12.0	11.3	11.1	10.3	10.5
Guatemala	8.6	7.6	7.2	6.3	5.3	6.1	7.0	8.1	8.7	7.8	6.8	7.3	8.2	7.8	6.7	8.0	8.8	9.4	9.6	10.0
Haiti	7.2	10.1	10.9	11.6	11.7	12.5	10.2	10.4	10.6	10.4	8.7	9.5	6.1	5.5	2.6	6.4	7.5	9.2	8.9	9.1
Honduras	14.2	12.7	12.7	11.8	13.5	14.0	13.5	14.0	11.7	11.8	14.1	14.5	15.4	14.8	14.3	15.7	14.4	14.1	17.0	17.7
Mexico	15.8	11.4	10.6	11.1	11.0	10.9	11.5	10.8	12.2	12.1	11.5	12.0	12.4	11.4	11.3	9.2	9.0	9.8	10.5	11.2
Nicaragua	22.2	19.5	21.5	25.9	30.6	27.7	27.8	24.8	19.2	21.7	13.5	17.7	19.2	18.7	19.3	20.6	20.7	23.0	24.1	23.0
Panama	13.9	14.3	13.7	14.4	13.8	13.8	14.5	14.7	9.6	8.2	11.7	12.5	12.5	12.1	11.8	12.5	12.1	12.5	12.1	12.6
Paraguay	8.4	7.5	8.2	6.4	6.6	6.9	6.8	7.0	6.9	8.8	9.5	9.4	9.3	9.4	10.7	12.2	11.5	11.8	11.6	10.8
Peru	15.8	13.2	13.0	10.7	11.6	13.4	11.3	8.4	7.7	6.1	7.7	8.9	10.0	10.1	11.2	11.6	12.1	12.1	12.1	11.4
Uruguay	15.5	16.1	13.6	14.0	12.5	13.6	14.7	15.0	15.4	14.3	14.4	14.3	14.9	14.7	13.1	14.6	14.9	15.8	16.1	15.4
Venezuela	5.9	9.9	9.2	9.6	9.9	11.0	12.9	8.6	7.7	4.5	3.7	4.4	5.5	7.2	8.7	8.2	7.9	9.8	10.3	10.3

Source: ECLAC, quoted in Tanzi, 2003:332.

Looking at the developments of tax revenues, there is a clear contrast between Bolivia's and Ecuador's performance: while Bolivia roughly doubled its revenues since the mid-1980s, Ecuador's revenues increased only slightly. It seems therefore that Bolivia did not only manage to introduce tax policies successfully (see Chapters 4 and 5) but that these tax reforms did result in significant increases in tax revenues. Ecuador's way of introducing changes to the tax system in a rather gradual and often inconsistent way led to a stagnation of revenues. Though this seems a positive development for Bolivia, increased tax revenues bring greater responsibility on the part of the state on how to spend the money collected. Of the two sides of fiscal policy Bolivia seems to have relied mainly on raising revenues rather than on cutting spending. As pointed out in Section 3.1, Bolivia failed to make progress concerning public spending as public sector employment increased during the 1990s (see also Chapter 8.4). It seems that this imbalance between increased levels of taxation and a lack of reduced spending on the side of the government has led to state-society tensions, which contributed to the political instability the country experienced during the last few years. As several interview partners pointed out there is an immense frustration in the Bolivian population about the lack of quality services the state provides in return for their tax payments (Doria Medina, Gray Molina, interviews, 25.5.+7.5.2004). In short, the increased revenues have not been accompanied by an improvement in the quality of services provided by the state. This aspect also helps to explain why the government's attempted tax reform of February 2003 was foiled by popular protest and why the pattern of a successful introduction of tax policies came to an end.

1.5 Why Ecuador and Bolivia?

More often than not it is the larger Latin American countries that are used as case studies, intensive research has been done on political economy decisions of Argentina, Brazil, Chile or Mexico. Research on the experiences of the smaller democracies is considerably less frequently undertaken and very little literature on Ecuador and Bolivia exists. This study makes a contribution to the literature by focusing on Ecuador and Bolivia, thus providing some evidence for the reform process of the smaller Latin American countries. A cross-country comparative approach has been chosen as it allows to establish a relationship between political phenomena. As Sartori (1994c:15) pointed out, comparisons *"control (verify or falsify) whether generalizations hold across the cases to which they apply"*.

The two cases were selected using the most-similar-method of comparative analysis: as many factors as possible are held constant so that the critical variables accounting for the differences in economic policy-making processes can be isolated. Despite important differences, Ecuador's and Bolivia's economic situations can be considered as broadly similar when contrasted to other countries of the region. Both countries are classified as Lower-Middle Income Countries by the World Bank and within the region they are among the poorest: while Ecuador was ranked as number 10 and 11 as regards GDP per capita within South America between 1986 and 2001, Bolivia took place number 12.[9] Both countries are heavily indebted, while Bolivia had a total debt service/exports ratio of 37.0 per cent on average between 1980 and 2002, Ecuador had 33.1 per cent on average during the same time period (WDI, 2005). Ecuador and Bolivia are both highly vulnerable to external economic conditions, not only because of the limited size of their economies but also due to their high dependence on export earnings of primary commodities. The two countries faced broadly similar external economic conditions in the aftermath of the Mexican default of 1982 when credits dried up and Ecuador and Bolivia were experiencing huge budget deficits (as did many other Latin American countries). There are certainly also significant differences – not least the fact that Ecuador is an oil economy. Yet in an overall assessment the similarities outweigh these. As concerns institutional arrangements, both countries can be broadly classified as presidential[10] and have a multi-party system. This allows for an analysis of more specific institutions that may be held accountable for affecting economic policy-making. The two Andean countries also share geographical, historical and cultural commonalities. Additionally, the countries share a lack of geopolitical power. In that respect neither of the two countries seems to be more vulnerable to external influence than the other. As regards the last few years the two countries share a history of overthrowing (or early retirement of) its leaders: Ecuador (Bucaram – 1997; Mahuad – 2000; Gutiérrez – 2005) and Bolivia (Sánchez de Lozada – 2003; Mesa – 2005). Both countries are currently marked by highly strained state-society relations and frequent outbursts of popular protest.

The time frame of this study is within the last two decades. More precisely, the period from 1984 to 2003 will be covered in the case of Ecuador, starting with the government

[9] Out of 12 countries (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Panama, Paraguay, Peru, Uruguay, Venezuela). IMF, 2005.

[10] Bolivia does not represent a purely presidential regime but rather one that can be defined as "parliamentarised presidentialism" (see Chapter 2.1).

of Febres Cordero during which a first significant tax reform was undertaken in the country's post-democracy period, and ending with the government of Noboa. The government period of subsequent presidents (Gutiérrez and Palacio) are not included as no significant changes to the tax system were introduced. The analysis of Bolivia considers the years 1985 to 2004 taking into account all governments since Paz Estenssoro (1985-89). The period of Mesa's presidency (2003-05) is included as his government attempted to introduce major tax changes in 2004.

1.6 METHODOLOGY[11]

The primary material used and gathered for this thesis comes from various sources.

Interviews. For this work, a total of 67 interviews (see Appendix B for a list) were conducted. The interviewees were involved at the policy-making level for certain periods during the last twenty years and most of them were chosen due to their involvement in the tax reforms analysed in this thesis. The interviewees included two former presidents, 13 finance ministers, six Central Bank presidents, eight members of parliament, three directors of the Internal Revenue Service, nine other ministers and vice-ministers. Other interviewees included directors and presidents of Ecuador's and Bolivia's main private sector organisations, second rank personnel of the same organisations as well as of the Ministry of Finance and the Internal Revenue Services, the Tax Superintendent of Bolivia, chairpersons of the legislative commissions dealing with tax reforms, representatives of prominent think tanks, tax lawyers, and academics. The interviews were semi-structured and in-depth. They were conducted as attributable, were tape recorded and subsequently transcribed.

Documents. To complement this material several types of documents were used. Newspapers proved to be an important source as they provided results of voting on tax reforms in the Congress, behind-the-scenes information, speeches, and evidence of dynamics of the coalitions. The Bolivian newspaper *El Diario* and the Ecuadorian *El Comercio* of the last two decades were consulted systematically at Colindale, the newspaper branch of the British Library. For articles of the last two to three years a wider range of newspapers was consulted via the internet. The minutes of the legislature's discussion on some of the tax reforms were researched in the Ecuadorian and Bolivian libraries of Congress. Several internal documents were provided by the Ministries of Finance and the Internal Revenue Services. Databases of the two Central

[11] For a more extensive outline of this methodology section see Appendix A.

Banks, the Internal Revenue Services as well as the International Monetary Fund (IMF) and World Bank were consulted for statistical data.

1.7 Main Findings

The pattern observed when analysing the tax reforms undertaken in Ecuador and Bolivia during the last two decades shows that there has been quite a difference between the two countries in the way they introduced tax reforms. While Bolivia managed to introduce wide-ranging reforms quite consistently during the 1980s and 1990s, projects in Ecuador often failed or were greatly modified. Since around the year 2000 the pattern in Bolivia changed as introducing reforms became more difficult for presidents and the general political climate turned more unstable culminating in the overthrow of President Sánchez de Lozada in October 2003 and the early end of Mesa's presidency in 2005. How can these patterns be explained?

While the findings of the research are outlined in detail in the concluding chapter, a short overview of these findings is anticipated here. The institutional explanation proposed proved to have explanatory power as it provided a coherent explanation as to why Bolivia was able to implement wide-ranging tax reforms during the 1980s and 1990s while presidents in Ecuador usually failed to introduce similar changes. Bolivia's particular form of presidentialism – featuring a parliamentary element of electing the president in Congress in the second round of elections – produced a pattern of coalition-building after 1985, which in turn allowed presidents to introduce wide-ranging tax reforms. In Ecuador, on the other hand, tax reforms often failed due to the lack of institutional incentives for overcoming the political deadlock of a fragmented Congress. While the hypothesised influence of institutional aspects on the economic policy process has thus been supported by the empirical evidence gathered, also other aspects were found to complement this approach and help explain the patterns that occurred in Ecuador and Bolivia.

A second finding contributes to the theoretical approach which argues that economic crises can account for economic reforms undertaken (see Chapter 8.3). The empirical evidence gathered showed that the crisis aspect in its broad version did not make a successful introduction of reforms more likely. The case of Ecuador's economic crisis of 1999 and the difficulties of Mahuad's government in introducing tax reforms in this situation are a good example. What did prove an important factor, however, was the existence of hyperinflation in Bolivia in 1985 which paved the way for drastic economic reforms in its aftermath. The wide-ranging tax reform Bolivia introduced in 1986 was partly possible due to the ruling coalition that existed at congressional level but also due to the fact that people were willing to accept such reforms given the traumatic experience of hyperinflation. Hyperinflation is thus an important variable and helps explain the different patterns of tax reforms of Ecuador and Bolivia. It shows that an economic crisis in the form of a hyperinflation has an impact on the policy-making process which is not necessarily the case when countries experience other types of economic crises.

While the patterns of policy-making in Ecuador and Bolivia had been strikingly different from each other during the 1980s and 1990s, this pattern changed during the last couple of years. In February 2003 President Sánchez de Lozada tried to introduce an income tax but failed to do so facing massive popular protest. Later during the year he was forced to resign and was succeeded by Carlos Mesa who struggled to introduce any reform while being in power and largely failed when attempting to have a tax bill approved in March 2004. How can this change of pattern be explained and what happened to coalition politics which had allowed previous governments to introduce reforms? And how can the extra-institutional overthrow of the tax reform in February 2003 be accounted for? While coalition politics on the one hand had the effect of providing Bolivia with a period of political stability lasting for almost twenty years and also allowed governments to introduce their economic reforms, it had a second effect which has slowly undermined the viability of the coalitions. These coalitions were dependent on the distribution of patronage, a feature which would become more and more dominating over the years. While Bolivia was a radical reformer as regards so-called *Washington Consensus* policies during the last two decades, it did not manage to reduce or significantly reform its public sector. The patronage logic of coalition politics prevented presidents from doing so. It seems, therefore, that "old politics" has been necessary for the introduction of "new economics" (Panizza, 2000). In the eyes of the public the traditional parties involved in the coalitions became more and more discredited as they seemed interested in little more than the side payments they received. The established parties received fewer and fewer votes, coalitions became more unstable and popular protest gained more and more momentum given the increasing frustration of Bolivians with the political establishment. Protest movements developed into a political force able to influence the policy-making process as protests reversed water privatisation in January 2000 or prevented the above mentioned income tax from being introduced in February 2003.

Coalition politics, in short, thus had a dual effect: it facilitated the introduction of economic reforms and led to political stability yet at the same time was a catalyst for political instability in the long run given its dependency on patronage payments. The extra-institutional processes Bolivia experienced during the recent years, then, were caused by the same institutional mechanism that had caused political stability during the 1980s and 1990s.

1.8 CHAPTER STRUCTURE

Following this introduction, the *second chapter* compares the political structures of Ecuador and Bolivia as regards their particular form of presidentialism. The constitutional powers of executive and legislature are considered as well as electoral procedures, aspects of the party systems and coalition formation. Particular reference is made to the institutional provisions regarding the introduction of tax reforms. *Chapter 3* outlines the economic situations of the two countries thus setting the background for the comparison. An overview of the *Washington Consensus* reforms undertaken in the two countries since their return to democracy is given. This analysis shows what has happened in other areas of economic reform and thus contextualises the tax reforms used as a case study. It also provides evidence that tax reforms have been representative for other economic reforms undertaken in Ecuador and Bolivia. *Chapters 4-7* contain a detailed case study of the tax reforms introduced in Ecuador and Bolivia since the 1980s. The Bolivian tax reforms introduced while coalition politics was still in place are analysed in *Chapter 4* (Governments of Paz Estenssoro, Paz Zamora, and Sánchez de Lozada). In *Chapter 5* the policy process during the period of Banzer, Sánchez de Lozada (his second government) and Mesa is considered, a time period where coalition politics gradually collapsed and during which Bolivia experienced a time of high political instability. *Chapter 6* looks at the tax reforms that occurred or were attempted in Ecuador during the governments of Presidents Febres Cordero, Borja, Durán Ballén and Bucaram, while *Chapter 7* focuses on those undertaken by Mahuad and Noboa. All the chapters and cases considered share a similar structure. Firstly the presidential elections are described, as is the process of forming a coalition (if applicable) including its patronage aspects, and the parties' representation in Congress. Having established the political background, the main policy reforms introduced by each government are briefly outlined. For every case of tax reform its main elements are given and the process of how it came to be introduced, how it failed, or how it was modified is investigated. A particular focus is put on the dynamics of executive – legislative relations and how Congress influenced the fate of reforms. However, to make the work more viable other variables are equally taken into account: the opposition and lobbying activities of economic interest groups, trade unions or social movements and the influence of external actors. By taking these different factors into account the whole story of these tax reforms shall be reconstructed to determine the decisive elements in each case. Every individual tax reform studied ends by examining the factors that explain why the reform either succeeded or failed. *Chapter 8* finishes with a comparison of the processes of tax policy-making in Ecuador and Bolivia and conclusions from the preceding chapters are drawn.

2 The Political System of Bolivia and Ecuador

This chapter will compare the political systems of Ecuador and Bolivia, with reference to the current literature on presidential regimes in Latin America. After providing a definition of presidentialism the regime type of Ecuador and Bolivia will be identified. Subsequently the discussion focuses on the constitutional powers of president and congress, electoral processes, the countries' party systems and coalition formation. Finally, hypotheses to be tested in the case study of tax reforms are developed.

2.1 Categorisation of Regime Type

Definition of presidentialism. Within the literature on presidentialist regimes several definitions have been offered: Lijphart (1984) stressed the aspects of the president's election for a fixed term and direct (or indirect) popular election as essential characteristics. Linz (1994) took on these standard features yet added a focus on the legislature as a defining feature. He stressed that in a presidential system both president and legislature are democratically legitimised, both are elected for fixed terms, and he emphasised the separate survival of president and legislature. Other scholars essentially crafted their definitions by drawing on these two (see, for example, Mainwaring, 1990; Mainwaring and Shugart, 1997b; Stepan and Skach, 1994). Some authors, however, went further and narrowed the definition down by making reference to the powers of a president. Sartori (1994b) included the president's right to appoint the cabinet and Shugart and Carey (1992) expanded this definition by a fourth element (apart from popular election, fixed terms, appointment of cabinet): they considered lawmaking authority granted by the constitution as another essential element of presidentialism. When analysing the regime types of Ecuador and Bolivia in the following the more specific definition of the aforementioned authors will be drawn upon.

Bolivia. Among those who explicitly attempted to categorise the Bolivian political regime, few considered it as presidential without at least making some qualifications (for authors who defined it as presidential see, for example, Jost, 1998:508). However, defining Bolivia's regime as presidential, or purely presidential, clearly contradicts the formerly established definition: although it fulfils the principle of fixed terms it partially violates that of popular election. In the Bolivian system a popular election is held to select a president in a first round; if neither of the candidates receives more than 50 per cent of the votes, however, the president is chosen by the legislature from among the first two (until 1994 from the first three) candidates of the first round.[12] Theoretically, therefore, the regime could be presidential at times: namely whenever a candidate receives a majority of votes in the first round. Considering the elections since Bolivia's return to democracy, however, the president has always been chosen in the second round only (and for the time being it seems unlikely that any candidate could gain the majority of votes in the first round). Thus, the president has ultimately not been elected by popular vote but by the legislature, a procedure common to parliamentary systems.

Secondly, several times the Congress has not elected the plurality winner of the first round. In 1985 the legislature favoured the second-placed Paz Estenssoro (MNR – *Movimiento Nacionalista Revolucionario*) over General Banzer (ADN – *Acción Democrática Nacionalista*) who had come first and in 1989 the legislature even elected Paz Zamora (MIR – *Movimiento de Izquierda Revolucionaria*) who had only received the third highest number of votes. These two cases show that the Bolivian legislature does make use of its constitutionally given right to choose the president in the second round. It does not act as a rubber-stamp to endorse the results of the first-round popular election, but has proven to be the decisive body in selecting a president. Given this practice Bolivia can be considered to feature a parliamentary principle in its political system: the election of the chief executive by the assembly. In the presidential elections since 1993, however, the Congress has endorsed the plurality winners of the first round: Sánchez de Lozada in 1993 as well as 2002 and Banzer in 1997. Since the constitutional reform of 1994 the choice of Congress has been limited to the first two vote-getters. It is likely that the change in the electoral procedures of the congressional round has influenced this new pattern of endorsing the plurality winner.

In short, given this evidence of presidential elections since 1985, Bolivia violates the principle of popular election common to other presidential regimes, as it is the legislature who makes the ultimate decision on the presidency. Though Bolivia can thus be considered as non-presidential as regards the origin of the chief executive, neither can the system be defined as being parliamentary: despite the dependency on the assembly for being elected, once in power the president's survival is independent of the assembly. Unlike in parliamentary systems, the Bolivian Constitution does not allow for a congressional vote of no-confidence. Given that the Bolivian regime is in accordance with only one of the principles of presidentialism (that of a fixed term of both president

[12] See Art. 90 of the Constitution of 1967 and Art. 90:I of the amended text of 1995. All references to the Bolivian Constitution taken from: Political Database of the Americas (PDBA), 2005a; 2003; 2005b.

and assembly) and violates the second (popular election), and since it does not provide for a vote of no-confidence essential for parliamentary systems, it can be considered as a mixed system. It is more in accordance with presidentialism than with parliamentarism since the election procedures are not purely parliamentary, as the first round has the format of a popular election, and as the post-election system seems purely presidential.

Gamarra (1997:363-364) defined the Bolivian political system as "hybrid presidentialism". While the term "hybrid" implies two different aspects it is only one that is named and there is no clear allusion to the fact that the Bolivian regime includes parliamentary features and provides for a prominent role of the legislature. Using the term "hybrid" to characterise Bolivia's political system may also be questioned for its double meaning (as the word hybrid is often used in a pejorative sense). Among the other scholars considering the Bolivian system as mixed are Shugart and Carey who used the term "assembly-independent regime", defined by them as a regime in which *"the origin of executive power is not separate from assembly power, but the survival of the two branches remains independent."* (1992:78). While agreeing with this definition, the term "assembly-independent" seems an unfortunate choice. It is a confusing term, as the crucial distinction between the Bolivian regime and other presidential regimes in Latin America is that the election of the president is not independent of the assembly but indeed dependent. It seems that Shugart and Carey (1992:161) by using this term intended to imply that it is the "assembly" that decides on the origin of presidents and that they are "independent" of the assembly afterwards. The term, however, does not appear to live up to its intended ideal: naming a regime "assembly-independent" evokes the impression that the chief executive is generally independent of the assembly. Among the few who have ventured to name the Bolivian political system is also Mayorga. He argued that the actual political regime of Bolivia can be described as "parliamentarised presidentialism". It is a system that is characterised by inter-party coalitions and by the congressional election of the president (Mayorga, 2001:105). Mayorga's categorisation seems apposite for two reasons: firstly, it expresses the mixed character of the Bolivian system and explicitly names its components. At the same time, however, it implies the predominance of presidential features over parliamentary ones. It makes clear that the Bolivian system is a modified presidential regime, in which the Parliament plays an important role. It seems thus well-chosen to use the noun "presidentialism" with an attributive adjective: parliamentarised presidentialism.

Secondly, this term avoids both the lack of clarity and ambiguity of the categorisation "assembly-independent" as used by Shugart and Carey, and the pejorativeness and lack of preciseness of the term "hybrid".

Ecuador. Defining Ecuador's regime type at first sight appears to be an easier task than in the case of Bolivia. Firstly, in Ecuador presidents are elected by popular vote: the Constitution[13] requires that if neither of the candidates receives the majority of votes in a first round[14], a majority runoff between the first two contenders takes place. Secondly, both president and assembly are elected for fixed terms: the president remains in power for four years as do the members of Congress.[15] Thus, it seems the Ecuadorian regime fulfils the criteria of a purely presidential regime and a number of scholars have consequently named it as presidential without making any qualification (see, for example, Dent, 2000; Grindle, 1993).[16] However, considering the third aspect of our earlier established definition of presidentialism, control over government composition, one finds that the Ecuadorian legislature used to have the power to dismiss ministers. Under the Constitution valid between 1979 and 1998 Congress had the right to interpellate and censure ministers of state (Art. 59:f), consequently, the principle of the sole control over government formation presidents hold in purely presidential regimes was violated. Given the provision for censure, which is granted to few Latin American legislatures only, Shugart and Carey (1992:41) have classified Ecuador's regime as "presidential-parliamentary".[17] The main distinguishing feature of this regime type is that both president and legislature have the right to dismiss ministers. With a new Constitution coming into effect in Ecuador in 1998, the Congress was deprived of its

[13] After the end of military rule, Ecuador implemented a new Constitution in 1979, which was reformed twice (in 1984 and 1996). In 1998 a new and currently valid Constitution has been adopted. When mentioning articles of the Constitution in the following I refer to the one from 1979 as reformed in 1984 when discussing the pre-1998 period. All references to the Ecuadorian Constitution taken from: PDBA, 2005c; 2005d; 2005e.

[14] Since 1998 candidates need to reach 40% only (plus a difference of at least 10% to the second-placed candidate) to be elected in the first round. It was hoped that this reform would provide an incentive for coalition-building as chances were now higher that a decision would fall in the first round. In the 1998 and 2002 elections, however, this rule has not made any difference.

[15] This, however, is only the case since 1998, until then assembly members elected on the national list and on the provincial list were elected for four or two years, respectively.

[16] Interestingly, quite a number of scholars writing about Ecuador's democracy do not discuss the regime type at all (see, for example, Biles, 1998; Conaghan, 1994a; Conaghan and Malloy, 1994).

[17] Since Shugart and Carey do not explicitly discuss the case of Ecuador, however, there is some ambiguity in their classification: elsewhere they put Ecuador half-way between a presidential and a presidential-parliamentary system (Shugart and Carey, 1992:160).

right to censure ministers, cabinet formation is thus exclusively in the hands of the president.

In conclusion, Ecuador can be considered as having had a modified presidential regime until 1998 given the provision of a "potent" vote of censure granted to Congress. The system violated the third principle of presidentialism: the president's sole control over government composition. Since the change of Constitution in 1998, however, the political system of Ecuador is in absolute accordance with the earlier given definition of presidential regimes as the right of the legislature to dismiss ministers was abolished.

2.2 Constitutional Powers of President and Congress

Having established the regime type of both countries, an analysis of the constitutional powers bestowed on the president and congress will define the systems of these two countries in more detail and facilitate a better understanding. The relationship between powers of the executive and the legislature is crucial to explain patterns of political processes. According to Shugart and Carey (1992) it is the balance of presidential-congressional powers which influences democratic stability and governance. The following sections focus on provisions regarding veto and decree powers, which represent the crucial aspects defining congressional-presidential relations. Other powers, such as emergency powers, control over government formation and rules on referenda will also be taken into consideration.

Veto powers. A veto constitutes one of the determining features of presidential power over legislation as providing presidents with veto power means that they have the right to block any law approved by the legislature. It is essentially a reactive power, which Mainwaring and Shugart (1997b:41) defined as allowing the president *"to defend the status quo against attempts by the legislative majority to change it"*. The veto is ubiquitous in the presidential regimes of Latin America; there are few constitutions that do not grant this power to the president. However, there are great variations between different forms of vetoes and the actual extent of power that is transferred by it.

One way to assess the nature of a president's veto is to consider the possibilities the congress has to counteract it. In both Ecuador and Bolivia the stakes for the legislature to overturn vetoes are high: a two-thirds majority is required to override it. The president can thus be considered as having a "strong" veto since a high degree of opposition and unity among the oppositional forces has to be given in congress to overturn it. However, the nature of veto power in Ecuador and Bolivia does in fact differ greatly. Distinguishing between total vetoes and partial vetoes will make these differences clear. While a total veto allows presidents to block a proposed bill as such, they have the power to pick elements they agree with and veto parts they disapprove of if the Constitution provides for a partial veto. A partial veto – which only few Latin American constitutions grant to the executive – thus shifts the balance of power between president and legislature clearly towards a predominant president. In Ecuador presidents have both a total and a partial veto at their disposal and can thus be considered as being in a more powerful position than their Bolivian counterparts (Art. 153). This powerful position of Ecuadorian presidents is even enhanced: in the case of a total veto, the Congress has no right at all to overturn it (while they can override a partial veto when gathering two thirds of the votes). However, there are some qualifications to these veto powers, which in turn, allows the legislature to act as a check on presidential power. Here one has to distinguish between the Constitution in effect since 1998 and the previous one of 1979, reformed in 1984 and 1996: in the Constitution of 1979 as reformed in 1984 the president is specifically denied to veto the budget and was thus deprived of blocking a crucial part of legislation (Art. 70). Secondly, should a president make use of a total veto, while not having the right to override it, the Congress had the possibility to call for a referendum on the vetoed bill (Art. 69). Presidents consequently had to decide carefully whether to use a partial veto and thus allow the legislature a potential override, or to use a total veto, which in turn, might have resulted in a referendum. Depending on the current popularity of the president a referendum of the voters might not always seem a desirable prospect for a president.[18]

The Constitution of 1998 brought important changes to Ecuador's political system: it no longer mentions that the president cannot veto the budget (Art. 130; 258). Secondly, the new Constitution altered the provisions regarding total veto powers: Congress has been divested of its right to call for a referendum in case the president uses a total veto on some legislative proposal. The only option at the disposal of Congress to ratify the originally intended law is a two-thirds override, however, after one year only (Art. 153). These two changes concerning budget legislation and total vetoes have essentially

[18] As an example how a referendum may negatively affect a president one might consider the referendum held in Ecuador in June 1986. Though not following a presidential veto, but even called by the President himself, it makes clear that a referendum might be something presidents prefer to avoid. Febres Cordero had called for a plebiscite on allowing independents to be elected to public office. The referendum was defeated by a two to one margin and contributed considerably to the deterioration of Febres Cordero's personal standing (see, for example, Corkill and Cubitt, 1988; Isaacs, 1993).

created a "stronger" presidency and have taken away some of the powers the Ecuadorian legislature previously held. In Bolivia, by contrast, the Constitution does not provide for a partial veto, the president is restricted to the option of vetoing a complete bill (Art. 76).[19] The referendum is a new institutional feature in Bolivia's political system: a law passed by Congress in July 2004 gave the right to convene a referendum to the executive, the legislature (needs approval of two-thirds majority), and the population (requiring support of 6 per cent of registered voters).[20]

In sum, the Ecuadorian political system bestows presidents with "strong" veto powers as they can oppose legislative proposals by using a total or a partial veto. Until 1998, however, the Ecuadorian Congress had some means to counteract at its disposal: in the case of a total veto it could resort to calling for a referendum, while being able to override a partial veto with a two-thirds majority. Under the new Constitution of 1998 Congress has been deprived of its right to call for a referendum, thus presidential veto power has been further increased. In Bolivia, in contrast, the Constitution allows for considerably less concentration of power in the executive: Bolivian presidents can merely resort to using a total veto, which may be overturned by a two-thirds majority in Congress.

Decree powers. In contrast to the veto powers, which give a form of passive power to the president, decrees are proactive allowing the president *"to establish a new status quo"* (Mainwaring and Shugart, 1997b:41). Rather than reacting to a legislative proposal of the congress, a decree power puts presidents in a position to legislate without involving the legislature. In the field of Latin American politics ruling by "decree" is an almost ubiquitous term. As Mainwaring and Shugart (1997b) have pointed out, however, in many Latin American presidential regimes this seemingly existing decree power is based on a semantic misunderstanding. In Latin America the term *decreto* is used not only for a president's right to issue new legislation but also for rule-making authority, which relates to existing legislation only. The term decree will here be understood in a narrower way so that presidential powers can be analysed more distinctively. The definition provided by Shugart and Carey who consider decree laws

[19] All references to the Bolivian Constitution are from the 1967 Constitution reformed in 1995 (PDBA, 2003). In case there have been changes to the original Constitution of 1967, these are mentioned.

[20] Excluded from referenda are questions of internal or external security, fiscal matters and the political division of the country (*Ley* 2769, 6.7.2004).

as *"those laws which the president can initiate and which maintain the force of law unless specifically rescinded (vetoed) by congress"* (1992:143) will be adopted.

Bolivia. Having thus defined decree laws, one finds that Bolivian presidents have the right to use regulatory decrees only, there are no provisions for legislative decree powers in the Constitution. At times, however, presidents managed to introduce wide-ranging changes despite being limited to the tool of regulatory decrees: this was the case of the famous *Decree 21060* by which President Paz Estenssoro introduced his New Economic Policy on 29 August, 1985. It was a reform programme aimed at liberalising the economy and reducing the state's role in economic development. The drafters of the reform had managed to formulate the decree in a way that all changes made referred to already existing legislation and thus the *21060* kept within the framework of a regulatory decree (Urioste, interview, 11.5.2004).

Ecuador. Ecuador's Constitution (since 1984), on the other hand, bestows the president with a right that Krsticevic (1992:139) called "indirect" decree power. Ecuadorian presidents are entitled to legislate by decree: however, solely as regards economic measures (including tax reforms). This is not a decree power in the absolute sense of coming into force in the moment of its announcement, because the Constitution allows the Congress to veto a decreed bill. Yet, if the legislature does not discuss it within fifteen days (30 days since the Constitution of 1998 came into force), it automatically becomes a law. Although the Congress is thus given some countervailing powers, it can still be considered as a decree power and concurs with the earlier given definition. The president also had the right to issue several decrees at the same time, thus making it impossible for the legislature to deal with all of them within fifteen days. During the presidency of Febres Cordero (1984-88) in Ecuador, for example, he sent fifteen economic laws to Congress at one point, some of which had more than 200 articles. Obviously, most of them came into force without even having been looked at by Congress (Corkill and Cubitt, 1988; Roldós, 1986). This possibility was ended by the Constitution of 1996 (Art. 88; Art. 155 Constitution of 1998) as it prohibited presidents (except during a state of emergency) from sending new decree legislation in case another project was still being considered by the legislature. In addition to this decree power, the Ecuadorian Constitution allows presidents to call for a referendum on any kind of legislative matter. This provides them with yet another potential instrument to rule without consulting the Congress (see Mainwaring and Shugart, 1997b:46). In conclusion, while the Bolivian system does not grant any decree power to its presidents, their Ecuadorian counterparts are in a more powerful position as they may introduce legislation by decree.

Other constitutional provisions. In terms of constitutional powers over legislation, veto and decree powers represent the main aspects defining the relationship between president and congress. Other constitutional features, however, also have an influence on congressional-presidential relations. These are briefly outlined below.

Emergency powers. The right to assume emergency powers and to suspend certain provisions such as civil liberties for a specified period of time is a common feature of Latin American presidential regimes. Both the Ecuadorian and the Bolivian constitutions allow the president to resort to this measure in case of a foreign invasion or internal disturbance. In both countries the legislature has the right to revoke a state of emergency declared by the president. Paz Estenssoro (1985-89) of Bolivia made ample use of these emergency powers: by declaring a state of emergency he managed to limit the protests against his New Economic Policy (see Chapter 4.2).

Vote of censure. Another crucial element influencing the balance of powers between president and the legislature is control over government formation. While in both countries the president names and dismisses the cabinet ministers (Bolivia, Art. 99; Ecuador, Art. 78:e, 1984; Art. 171:10, 1998) the regimes have long differed substantially in their provisions for giving the Congress a voice. Bolivia does not grant any decisive power to the legislature: though the legislature may pass a vote of censure on cabinet ministers by a two-thirds majority it does not compel the president to actually dismiss the minister. Thus, not only are the stakes high to pass a vote of censure, it also may have no consequence at all and hence merely bestows the Bolivian Congress with the right for a symbolic rebuke of cabinet ministers. In Ecuador, as mentioned earlier, until 1998 the legislature had the right of votes of censure. This right was used extensively by the legislature: between 1979 and 1996 ministers were threatened with a vote of censure on 190 occasions (Sanchez Parga, 1998:84); 37 interpellations were ultimately carried out and 18 ministers were effectively censured (Burbano and Rowland, 1998:105). While 18 impeachments might appear a relatively modest number one has to keep in mind that ministers often resigned in anticipation of a vote of censure when facing a threat of being interpellated by Congress. The main target group of interpellations were the finance ministers, who were accused of everything from human rights violations or sugar price increases to administrative irregularities

(Conaghan, 1994a:343). The institutional aspect of a vote of censure has led to a high turnover of finance ministers and in consequence has resulted in great instability in this position so crucial for the development of economic policies. Between 1979 and 1998 finance ministers' average term in office was 11.25 months (see Appendix C).

Considering the case of the tax reform undertaken in 1989 under finance minister Jorge Gallardo it seems striking that this period was the longest a finance minister held this position during the last 25 years. Gallardo remained Minister of Finance for 29 months. It can be assumed that this continuity (and the apparent support he must have enjoyed) contributed to a successful attempt at reforming the tax system (see Chapter 6.2). The Congress can consequently be considered as having been in possession of an important countervailing power opposite the president given their right to censure ministers. Since 1998, however, this congressional power has been restricted: while the currently valid Constitution still allows the legislature to censure ministers, it transfers the ultimate decision about the minister's dismissal to the president thus essentially making the vote of censure as "toothless" as Bolivia's (Art. 130). A member of the Ecuadorian Congress has commented that *"since the authority to dismiss functionaries has been taken away from Congress, these processes are pure bla, bla"*.[21] It needs pointing out, however, that the volatility in the Ministry of Finance has continued even after the vote of censure had been abolished in 1998. This is in part related to the fact that since then there have been four different governments (Mahuad, Noboa, Gutiérrez, Palacio) while there would have been only two had Mahuad and Gutiérrez been able to end their terms. On the other hand this volatility has been related to the fact that in the unstable political environment of the last years presidents seem to have frequently chosen to dismiss some of their ministers to soothe public discontent with their governments. As former finance minister, Alfredo Arízaga, commented: *"In this environment of permanent conflict the ministers are the fuses that are blown to allow maintaining the government's stability."* (Arízaga, interview, 31.3.2004)[22]

In sum, with the introduction of a new Constitution in Ecuador in 1998, the congressional-presidential balance of power has been considerably changed in favour of the president. By depriving the legislature of its potent vote of censure that it formerly held, more power has been concentrated in the executive.

[21] León Roldós in *"Congreso aprobó 21 leyes y vetos del Ejecutivo"* (Hoy, 3.6.2002). All quotes from newspapers are my translation.

[22] All quotes from interviews are my translation. When adding a word or phrase to a quote I will mark it with my initials, SL. See list of interviews in Appendix B.

2.3 Assessing Constitutional Powers

Table 2.1: Constitutional Powers of President and Congress

	President's Powers	Congressional Powers
Bolivia		Elects president[1]
	Total veto	Override by two-thirds majority
	No decree power	
	Emergency powers	Revocation of state of emergency
	Names and dismisses ministers	
Ecuador	Total veto	*Until 1998:* no override, but may request a referendum *Since 1998:* two-thirds override after one year, no referendum
	Partial veto	Override by two-thirds majority
	Decree power for economic reforms	Veto within 15 days
	Emergency powers	Revocation of state of emergency
	Names/ dismisses cabinet ministers	Vote of censure on cabinet ministers (until 1998)[2]
	May call referenda	

Source: based on Constitución Política de Bolivia, 1967 + con reformas de 1994; Constitución Política de la República de Ecuador, 1984, 1996, 1998.

[1] The Congress elects the president in case no candidate receives more than 50% of the votes in the first round. Since 1997 Congress chooses from the first two vote-getters, previously from the first three.

[2] Until 1998 the Constitution gave Congress a decisive vote of censure: censured ministers were forced to resign (Art. 59:f, 1984). The current Constitution, however, has considerably weakened this power, as now the ultimate decision about the fate of the censured minister falls to the president (Art. 130, 1998).

Tables 2.1 and 2.2 show that considering presidential and congressional powers together rather than presidential powers only (as do, for example, Mainwaring and Shugart, 1997a) allows for a more comprehensive assessment of the political systems of Bolivia and Ecuador. Looking at the presidential side of powers only, one misses out potential countervailing powers of the legislature, which in effect might balance the presidential-congressional relations. Taking into account powers of Congress, some qualifications have to be made in the assessment of Bolivia having a "weak" presidency and Ecuador a "weak" Congress, essentially suggested by Mainwaring and Shugart (1997b). In Ecuador under the Constitution in effect until 1998 the legislature was bestowed a countervailing power for every presidential right. It could call for a referendum in response to a total veto, override a partial veto by a two-thirds majority, veto legislation decreed by the president, revoke states of emergencies and most significantly Congress could censure ministers. However, the stakes for many of these countervailing powers were rather high: for example, a referendum was rarely called for by the legislature and gathering a two-thirds majority in a highly fragmented Congress is a difficult endeavour. Hence, even though the Ecuadorian legislature was granted powers to overturn presidential initiatives, some of them were difficult to put into practice. The most powerful device of the legislature was the vote of censure. With the introduction of a new Constitution in Ecuador in 1998, the balance of power between president and Congress shifted markedly towards an even more dominant president: most significantly, Congress was deprived of its right to effectively censure ministers and of its option to call for a referendum in case of a presidential total veto. Ecuador's Constitution thus provides its president with extensive powers, such as decree and emergency powers, total and partial vetoes, the sole control over government formation and the possibility to call for a referendum. By comparison, Bolivia's presidents are in a weaker position as they are neither provided with decree power nor with a partial veto. Still, Bolivian presidents have control over cabinet formation and are provided with a total veto difficult for the legislature to overturn. The Bolivian Congress, in turn, is in a powerful position as it elects the president and potentially has a larger role to play in the legislative process given the absence of presidential decree and partial veto power.

Table 2.2: Presidential Powers and Countervailing Powers of Congress

Bolivia		Ecuador	
President	**Congress**	**President**	**Congress**
	+ Elects president		
+ Total veto	+ Two-thirds override	+ Total veto	+ Referendum*
		+ Partial veto	+ Two-thirds override
		+ Decree powers	+ Veto
+ Emergency powers	+ Revocation	+ Emergency powers	+ Revocation
+ Cabinet formation		+ Cabinet formation	+ Vote of censure*
		+ Referendum	

Source: Own elaboration. Based on *Constitución Política de Bolivia*, 1967 + with reforms of 1994; *Constitución Política de la República de Ecuador*, 1984, 1996, 1998. * Until 1998.

In sum, Ecuador's presidents are granted rather extensive legislative powers which in Latin America is is also the case in Chile, Brazil and Colombia. Bolivia's weak presidential powers are comparable to those in Costa Rica, Nicaragua and Paraguay (Stein et. al., 2005:48).

2.4 LEGISLATIVE PROCESS

In the following the process of introducing legislation in Ecuador and Bolivia will be outlined. Particular reference will be made to provisions for tax legislation.

Ecuador. In Ecuador's unicameral system bills have to be approved by the legislature in a simple majority vote and both executive and legislature have the right to present law proposals.[23] As regards the area of taxation, however, the power of the legislature was significantly restricted with the introduction of a new Constitution in 1998, which deprived the legislature of the power to initiate tax reforms and granted it solely to the president (Art. 147, Constitution 1998). The legislature has thus been limited to reacting to the president's proposals in this matter. After the executive has sent the bill to Congress the usual process is as follows: the project is distributed among the deputies and sent to the legislative commission responsible for taxation which analyses the project and sends a report to the legislature. In a first debate observations are made and the bill is then returned to the commission, which prepares a second report on the basis of the comments given. In a second and final debate, the bill is discussed in the legislature article by article, which are approved, modified or rejected. While this procedure appears to allow the legislative commissions some room for manoeuvre, their influence on policy-making seems to have been rather marginal as became clear in several interviews with presidents and members of the commission responsible for taxation (see, for example, Minuche, Bustamante, interviews, 20.4.2004, 25.3.2004).

When sending a tax proposal to Congress, presidents have the option to either send it as an ordinary law, or to send it as an economic law marked as urgent (see section on decree power above). This gives very little time – 15 days until 1998 and 30 since then – to the legislature for discussing the law. When failing to comment on the bill presented, it would come into force by default. Practically all tax reforms initiated by the executive during the last two decades have been sent to the legislature in this way, as the alternative – to send it the ordinary way – would have meant a bill would probably take years to be approved (Ruales, interview, 23.3.2004). As mentioned earlier prior to the 1996 Constitution presidents were allowed to send an unlimited number of urgent economic laws. As regards tax reform, this provision allowed President Febres Cordero to increase the VAT from 6 to 10 per cent in 1986 as the tax bill was one among many of these bills marked as urgent and which Congress could not process

[23] Ecuador's Congress currently has 100 members (71 between 1979-1992, 77 in 1992-96, 82 in 1996-98, 125 1998-2003).

within a period of 15 days. Given, however, that this possibility was abused by Febres Cordero, his successors did not take recourse to this procedure to the same extent and it was formally abolished in 1996.

The Ecuadorian Constitution granted the right to decide on a piece of legislation not only to the Congress but also to its proxy body, the *Plenario de las Comisiones Legislativas*[24] (Article 65 of the 1979 Constitution – modified in 1984 – and Article 88 of the 1996 Constitution). The *Plenario* consists of the members of the legislative commissions (four commissions with 28 members in total between 1984 and 1994; five commissions with 35 members since 1995) and convenes during the periods of the year when the full Congress is on vacation. While arrangements like the *Plenario* to provide continuation of legislative work are a common feature of Latin American presidential systems, it is highly unusual that this body had the right to decide on bills. It seems that in all other Latin American countries an extraordinary session of the full Congress has to be convened if a law is to be approved outside the congressional periods. In no case can anyone but the Congress decide on legislation. Granting this power to the *Plenario* is therefore a unique feature of the Ecuadorian system. In 1998, however, this procedure was abolished as the new Constitution established that all laws have to be discussed in Congress. Another rather striking fact is that only since 1996 was the composition of the *Plenario* required to be proportional to the composition of the Congress.[25] It could thus occur that the representation of parties in these two legislative spaces differed. Most markedly a distortion existed in the first half of President Borja's government, between 1988 and 1990, when his ruling party fell short of holding a majority in the Congress but did hold a comfortable majority in the *Plenario.* As will be outlined later, Borja managed to take advantage of this situation by sending his proposed tax reform to the legislature at a time when the Congress was on vacations and the bill could thus easily pass in the *Plenario* (see Chapter 6.2).

Once the executive's reform proposals have been either approved, rejected or modified by either the Congress or its proxy the *Plenario*, Ecuadorian presidents have the option of putting either a total or a partial veto (see section above). Though many tax initiatives of the executives were turned down by the legislature, presidents hardly ever took

[24] Plenary of Legislative Commissions. Hereafter *Plenario* will be used.

[25] In Article 31 of the Organic Law of the Legislative Function (*Ley Orgánica de la Función Legislativa*; organic laws state a country's constitution) the following section was added in 1996: "The *Plenario* of the Legislative Commissions has to be composed in proportional relation to the representation which the different political parties and the disaffiliated have achieved."

recourse to this option, probably to avoid further conflict with Congress. The only exceptions occurred in 1999 under Mahuad and in 2001 when President Noboa vetoed the decision of the Congress to turn down his bill regarding an increase of the VAT rate (see Chapter 7.1,2). Considering the constitutional provisions to introduce laws, tax laws in particular, presidents in Ecuador seem to be equipped with rather favourable powers: it is only the executive who has the right to propose tax reforms since 1998; they can be sent marked as urgent thus leaving very little time to the legislature for deliberation; and finally presidents have wide-ranging veto powers at their disposal they could use in case Congress would turn down their initiatives. What is unusual about the Ecuadorian system is that until 1998 it allowed a body other than the Congress to decide on legislation, as was the case of the *Plenario*, which was not required to be proportional to the composition of Congress.

Bolivia. Given that Bolivia has a bicameral system any piece of legislation has to be approved by both chambers of the Congress.[26] Initiating tax reforms is not limited to the executive but both chambers of the Congress can also present projects. Bills are usually discussed in the Chamber of Deputies first where the discussion – in a similar way as in Ecuador – proceeds in two rounds between which the legislative commission responsible (Economic Commission) integrates proposals for modification that arose in the legislature. The commission is required to write a report within a period of 15 days after the first discussion. Just as in Ecuador, this legislative commission does not have a decisive influence on tax policy-making and usually reacts to the initiatives of the executive (Inch, interview, 13.5.2004). In the second discussion a decision is taken in the Chamber of Deputies and the bill is then passed on to the Senate. While the Senate has the power to stop the introduction of laws, in practice it has made rare use of this possibility and has generally followed the decision taken by the lower chamber. A simple majority in each chamber is needed to approve laws. In response to the legislature's verdict on the tax bill, the president has the possibility to veto the decision (see section on veto power above). This veto can only take the form of completely vetoing the approved law rather than vetoing parts of the bill (as the Ecuadorian Constitution allows). The legislature needs to gather two-thirds of the votes to overturn the presidential veto. In sum, in Bolivia the powers granted to executive and legislature to introduce tax legislation are more balanced than in Ecuador: both have the right to

[26] The *Cámara de Diputados* (Chamber of Deputies) currently has 130 members (117 between 1984-1997) and the *Cámara de Senadores* (Chamber of Senators) 27 members.

initiate reforms, the time taken to discuss the reforms is left to the Congress, and finally the president only has a total veto at his disposal to overturn decisions taken by the legislature.

2.5 PARTY SYSTEM

After having defined the political regimes of Ecuador and Bolivia and having examined the constitutional powers of presidents and congress, the party systems of both countries will be considered.

Table 2.3: Number of Parties in Congress, Bolivia + Ecuador

Number of parties in Congress			
Bolivia		Ecuador	
1985-89	10	1984-86	13
		1986-88	13
1989-93	5[a]	1988-90	11
		1990-92	11
1993-97	9	1992-94	12
		1994-96	13
1997-2002	7	1996-98	11
		1998-2003	13[b]
2002-	8	2003-	18[b]
Average	7.8		12.7

[a] New legislation of 1986 made the system of seat allocation less proportional. As pointed out by Domingo (2001:150) the law was ambiguously phrased and in the 1989 elections the *Corte Nacional Electoral* (National Electoral Court, CNE) took the liberty to interpret it in a way that favoured the large parties. This way only five parties entered the Congress. According to Domingo another two would have achieved presentation had the law been interpreted differently. Romero Ballivian, of the electoral court, considered that the decision was a result of the politicisation of the electoral court at that time (Romero Ballivian, interview, 28.4.2004). Due to these proceedings, the way members of the electoral court are elected was changed in 1991 and the electoral system was reformed mainly through legislation introduced in 1996.

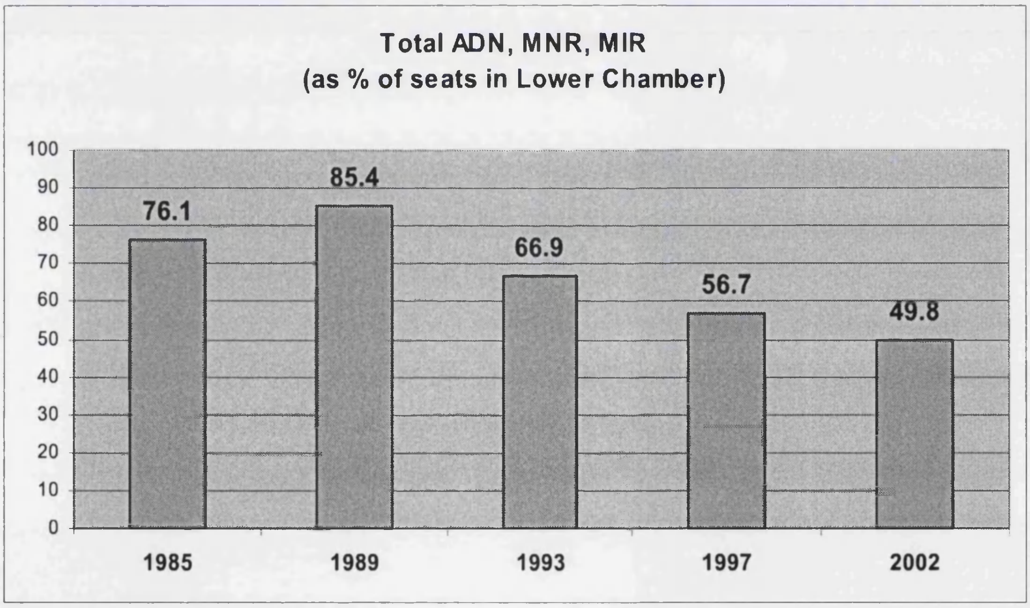
[b] Prior to the 1998 elections parties were not allowed to form alliances and had to present their own candidates. Since then, however, a high number of deputies in Congress competed in the elections on a joint list rather than under a single party label. This has led to a dispersion of parties represented in Congress (Pachano, interview, 18.3.2004). In "1998-2003" and "2003-" I have counted all parties represented individually or via a joint list. E.g. in the case of the 2003 elections there have been 14 parties holding seats under their party label plus eleven joint lists of two parties holding one or more seats. I have counted the 12 parties plus those parties, which have gained representation via a joint list but not individually (of which there were six).

Source: Own elaboration. Based on data from TSE (2004), Observatorio Electoral (2005), CNE (2005b).

Bolivia. Bolivia's party system can be categorised as a fragmented multi-party system. Between 1979 and 1997 a total of 28 parties participated in presidential elections and the average number of effective parties between 1979 and 1993 has been 4.0, 4.7 in

1993 (Mainwaring and Scully, 1995:30) and 5.5 in 1999 (Chasquetti, 2001:354).[27] Despite this fragmentation, however, there is some consistency as the candidates elected to the presidency have always come from the parties ADN, MIR or MNR. These three parties have also constantly taken the first three places in all presidential elections between 1985 and 1997. Gamarra and Malloy (1995:420) have consequently named Bolivia's party system a *"three-party-dominant multiparty system"*. The popularity of the three parties has gradually and steadily declined, however, as they received less and less votes from one election to the other. While the ADN, MNR and MIR had received more than two-thirds of the votes in the elections of 1985 and 1989, they lost more and more of their supporters, by 2002 falling below 50 per cent of the votes (see Table 2.4). Other parties which had participated in the coalitions also saw their representation greatly diminished (as did the UCS), or completely disappear (as was the case of CONDEPA).

Table 2.4: Total ADN, MNR, MIR, 1985-2002



Source: Own elaboration. Data from Observatorio Electoral, 2005; CNE, 2005b.

As regards the parties represented in Congress, the number has been considerably lower than has been the case in Ecuador: while an average of 7.8 parties has been represented in each legislature since 1985 in Bolivia, the number for Ecuador since 1984 has been 12.7 (see Table 2.3).

[27] All authors have based their calculations on Laakso's and Taagepera's (1979) framework for determining the number of "effective" parties, which takes into account their relative size.

The degree of ideological polarisation expresses the extent to which votes are dispersed between parties on the left or right spectrum. An interesting fact about the Bolivian party system is that has become less polarised since the 1985 elections. The three main parties dominating Bolivian politics between 1985 and 2003 (MNR, ADN, and MIR) took clearly different positions on the left-right scale to begin with. From 1985 onwards and with the start of the introduction of market-oriented policies, however, these parties' ideological differences declined. With the emergence of parties like the *Movimiento al Socialismo* (MAS) in the political arena, however, the degree of polarisation has increased again.

Ecuador. While Bolivia's effective number of parties seems high already, the Ecuadorian party system is even more fragmented: in the five presidential elections taking place between 1978 and 1992 the mean number of effective parties was 5.8, 6.6 in the election of 1992 (Mainwaring and Scully, 1995:30) and 5.43 in 1999 (Chasquetti, 2001:354). Another indicator of the degree of fragmentation is that at least twelve parties have obtained representation in Congress in the elections between 1984 and 1998, a number that has even increased since then (see Table 2.3). Whereas in Bolivia the presidency has rotated between three parties, in Ecuador every election since 1979 has brought a president from a different party to power.[28] Conaghan (1994a) described Ecuador's party system as one being characterised by "floating" voters as well as "floating" politicians. By this she referred to the high volatility in the behaviour of voters as well as the politicians' frequent change of party. A survey of 1991 showed that 32 per cent of all elected members of Congress had changed their party affiliation at least once between 1978 and 1988 (cited in Conaghan, 1995:448-9). More recent numbers confirm this trend: as Table 2.5 shows during 1992 and 1997 between 17 and 27 per cent of the members had broken away from the party that they had stood for on their election within a year after legislative elections brought into being a new Congress. It is worth noting that no disaffiliations took place during the first two years of the Borja government (1988-90), the time when Ecuador's most significant tax reform was introduced (see Chapter 6.2).

[28] There have been eleven presidents from eight different parties since 1979 three presidents, however, have not been elected: 1979 – Roldós, CFP; 1981 – Hurtado, DP, Vice-President named President after the death of Roldós; 1984 – Febres Cordero, PSC; 1988 – Borja, ID; 1992 – Ballén, PUR; 1996 – Bucaram, PRE; 1997 – Alarcón, FRA, President of Congress named President; 1998 – Mahuad, DP; 2000 – Noboa, Independent, Vice-president named President; 2003 – Gutiérrez, PSP; 2005 – Palacio, Independent, Vice-president named President.

Table 2.5: Party Disaffiliations by Members of Parliament, Ecuador

Installation of Congress	Date	Disaffiliations
August 1988	August 1990	None
August 1990	August 1991	10%
August 1992	August 1993	18%
August 1994	August 1995	17%
August 1996	February 1997	21%
	November 1997	27%

Source: Own elaboration. Data from Burbano and Rowland, 1998:34,36.

Another prominent aspect of Ecuador's party system is its highly "personalist" nature. Coppedge went as far as saying that *"instead of party politics there is a politics of personality"* (1998b:197). This "politics of personality" has been embodied by the politician Velasco Ibarra who dominated Ecuadorian politics during a period of almost forty years, between 1933 and 1972 (see, for example, de la Torre, 2000). His style of promoting personal loyalty rather than loyalty to a party has marked the political system deeply up to the present day. As Coppedge (1998b:555) has shown, Ecuador was the only Latin American country where the personalist vote constantly exceeded 10 per cent.[29]

Parties seem to be mainly instruments for gaining office, which can be amply illustrated by two incidents: In 1992 Ballén, who had been a long-standing member of the *Partido Social Cristiano* (PSC) and twice its presidential candidate, simply left his old party after it had denied him the presidential nomination this time.[30] He founded a new party, the *Partido Unión Republicana* (PUR), in order to be able to compete for the presidential office, and subsequently won. Another example for the lack of esteem for political parties by politicians or presidents themselves is the attempt of Febres Cordero to change the Constitution. In 1986 he called for a plebiscite on a constitutional reform, which would allow independent candidates to be elected. While then rejected, in another referendum – this time carried out by President Durán Ballén – the same proposal was accepted and since 1996 candidates are no longer required to be affiliated to a party. According to political analyst Simón Pachano this change caused a considerable

[29] Coppedge used data covering the elections between 1966 and 1994. For his methodology see Coppedge, 1998b.

[30] For more information on the PSC and other parties see Appendix F.

weakening of the traditional political parties as their election results declined in consequence (Pachano, interview, 18.3.2004).

Parties in Ecuador are also strongly characterised by their regional divide between the *sierra* and the *costa*; most parties receive strong electoral support only in one of these two regions. The PSC, for example, is predominantly based in the *costa*, while the *Izquierda Democratica* (ID) has its base in the *sierra*. Within Latin America Ecuador has one of the least nationalised party systems, meaning that parties win widely varying voter support across the country's provinces, a feature that it shares with Peru, Argentina, Venezuela, and Brazil (Jones, 2005:25). As Ecuador's parties are mainly personalist in nature its degree of ideological polarisation is consequently low. As former mayor of Quito, Rodrigo Paz, pointed out: *"There are no ideologies, ideas diminish and personal aspirations prevail."* (quoted in Conaghan, 1995:456). In comparison to Bolivia, however, Ecuador's party system is much more ideologically diverse (Coppedge, 1998b:561).

In both Ecuador and Bolivia links between parties and society have historically been weak (Mainwaring and Scully, 1995:13). Party legitimacy is among the lowest of the region: as a Latinobarómetro poll of 2003 has shown party legitimacy reached 12 per cent only in Ecuador and 19 in Bolivia, compared to 47 per cent reached at the upper end of the scale in Uruguay. Less than one fifth of the Ecuadorian population thinks that parties are indispensable compared to 30 per cent in Bolivia and 59 in Uruguay. While 6 per cent have confidence in their parties in Ecuador, 8 per cent do so in Bolivia and 34 per cent in Uruguay (quoted in Jones, 2005:79).

2.6 Electoral Procedures

It is often argued that the nature of the party system and the degree of fragmentation is to a great extent determined by electoral procedures. Shugart and Carey (1992) demonstrated that electoral rules and electoral cycles play an important role in shaping the character of a party system. They claimed that majority elections of the president and non-concurrent elections generate fragmented multi-party systems. Another important aspect is the procedure for allocating seats, such as proportional representation. Mainwaring (1990) argued that multi-party systems emerge where elections are not concurrent – meaning that the first round of the presidential election is not held together with elections for the legislature – and where proportional representation is used. If, by contrast, elections do coincide, a two-party system tends to emerge even when a system of proportional representation is applied. Considering Ecuador and Bolivia, however, these cases do not seem to support Mainwaring's hypothesis as both countries have concurrent elections yet still both countries have a multi-party system. It is interesting to note, however, that in Ecuador the party system has been more fragmented in mid-term elections than at those times when presidential and congressional elections coincide (Shugart and Carey, 1992:224).[31] As regards the second aspect of Mainwaring's hypothesis, both Bolivia and Ecuador allocate seats in Congress on the basis of proportional representation.

Bolivia. In Bolivia a system of closed-list proportional representation was in place until 1997. Without being required to fulfil any quota, all parties were eligible to obtain seats according to largest remainders, which favoured smaller parties. The Bolivian party system has traditionally been highly fragmented and particularly in the period of transition to democracy the proliferation of parties reached rather high levels. Parties were often called "taxi parties" given that the number of its members would fit into a taxi. Legislation was put into place to limit this proliferation: from 1979 onwards parties which received less than 50,000 votes during an election were required to pay its share in the costs of printing the ballot papers. Should they be unable to raise the money, they would lose their right to exist as a political party. In practice this mechanism did function as a form of threshold as in several cases parties were unable to pay and in consequence ceased to exist (Romero Ballivian, interview, 28.4.2004). With new legislation introduced in 1996 this mechanism was replaced by a threshold, which required parties to receive 3 per cent of the votes in order to qualify for representation in the legislature (in addition, when failing to achieve 3 per cent once, the party is banned from ever standing for election again). While this provision alone would have had the effect of reducing the number of congressional parties, another change in the electoral rules, however, had a countervailing effect. Until the elections in 1997 all 130 members of Congress were elected in a closed list system and seats distributed according to proportional representation. From 1997, however, a mixed system was introduced in which 68 members of Congress – the so-called *uninominales* – are elected in a first-past-the-post system in 68 constituencies, while the remaining 62 seats continue to be allocated by proportional representation (*Ley* 1704, 2.8.1996). Previously, party leaders controlled party lists as they selected and allocated places to candidates, which made

[31] Due to the fact that provincial deputies had two-year terms until 1998, elections took place biannually thus alternating between joint presidential and congressional elections and pure elections for congress.

politicians dependent on their approval. The system of closed list proportional representation has generally been considered to have strengthened the influence of party leaders and discipline within parties. This was also confirmed for the case of Bolivia in a World Bank report of 2000 (World Bank, 2000a:47). Under the new system, party leaders maintained this leverage over only about half of the deputies and had no power over the appointment of candidates standing for election in the remaining 68 districts. Party discipline was consequently undermined as directly elected Members of Parliament had more incentives to be loyal to their constituency (to increase their chances for re-election) than to their party leaders.

"It had a completely counterproductive effect because it has destroyed the discipline of the parties. These 'uninominal' Members of Parliament do not feel like representatives of the nation but like attorneys of their region." (Urioste, interview, 11.5.2004)

The resulting lack of discipline mentioned by Bolivian constitutionalist Urioste, seems to be mirrored in the fact that presidents Banzer (1997-2002) and Sánchez de Lozada (2002-3) had far greater difficulty keeping their coalitions together from 1997 onwards than had previously been the case.

Given that the directly elected candidates are allocated seats in Congress independent of their party overcoming the 3 per cent threshold or not, the number of parties represented in the legislature can potentially be higher than would be the case in a pure proportional representation system applying a 3 per cent threshold. This occurred in the elections of 2002 where only six parties achieved 3 per cent, yet also the *Partido Socialista* (PS), winning 0.7 per cent in total, gained one directly elected seat, and the MIP (*Movimiento Indígena Pachakuti*) even had six of its members directly elected to the legislature (having received 2.2 per cent in total). In summary, while the 3 per cent threshold that was introduced in 1996 aimed at reducing the degree of fragmentation in the Congress, the simultaneously applied "mixed" system of electing deputies had the opposite effect as it allowed parties to gain representation without winning 3 per cent. In consequence, the new legislation has only slightly lowered the number of parties represented, as there were nine parties in the pre-reform elections of 1993, seven in 1997 and eight in 2002 (see Table 2.3).

Ecuador. In Ecuador seats are allocated by proportional representation according to the system of simple quota and largest remainders. No threshold has ever existed. The high number of parties in the legislature was mentioned earlier; it is likely that the system of proportional representation has contributed to this effect. In 1978 a *Ley de Partidos* was introduced, which aimed at limiting the number of parties competing in elections. The most significant requirement put down by this law is that parties have to receive at least 5 per cent of the votes in two successive congressional elections in order to be eligible to stand in subsequent elections. Theoretically, this could have a profound impact on the party system and actually reduce the number of parties considerably. However, in practice the law did not work out as intended and failed to reduce the number of parties significantly. Parties were often allowed to register again and to continue standing in subsequent elections despite having failed to fulfil the 5 per cent requirement. To give some examples, the *Frente Amplio de Izquierda* (FADI) competed in elections and obtained seats in Congress in each of the five congressional elections between 1979 and 1990 despite continually failing to receive 5 per cent. According to the *Ley de Partidos* the *Partido Conservador Ecuatoriano* (PCE) should have been forbidden to contest in the elections of 1990 since they did not receive the required share of votes in the two preceding elections; the *Frente Radical Alfarista* (FRA) should equally have been disqualified after the elections of 1990. The former president of the *Tribunal Supremo Electoral* (Supreme Electoral Tribunal, TSE), Patricio Vivanco, confirmed the failure of enforcing this rule and even said that the rule *"has never been respected"*. He assumed that in case the law had been applied, possibly Ecuador would now only have three parties as the others would have disappeared (Vivanco, interview, 1.4.2004). Up until 1997 Ecuador used a closed-list system, hence voters were not able to indicate the candidate they preferred from the party list, the chances for candidates to be elected was dependent on their number on the list, and the ranking and selection of candidates was in turn decided by the party leader. In the mid-1990 the system was changed and in the elections to the Constituent Assembly in 1997 for the first time open lists were used and seats were allocated according to the votes candidates received independent of the percentage gained by their party. Already in 2000, however, the system was changed again, closed lists came back and seats were distributed via the D'Hondt system of proportional representation. In March 2004 the *Tribunal Constitucional* (Constitutional Tribunal, TC) declared the D'Hondt system as unconstitutional.[32] The Congress did not manage to agree on a formula and left the decision for the upcoming regional elections (17 October, 2004) to the TSE. The TSE opted for the Imperiali quota (a formula that

[32] Several interview partners held the opinion that the PSC took advantage of its majority in the TC to invalidate this system that favours minority parties (Morillo Battle, Vivanco, interviews, 7.4.2004; 1.4.2004).

favours the larger parties). The formula was then used for the 2004 elections; since then no decision has been taken and Ecuador remains without an electoral formula.

Both countries use majority elections to determine the president, requiring candidates to receive a majority of votes in the first round of elections (40 per cent only in Ecuador since 1998). Given the unlikelihood of any candidate receiving more than 50 per cent (or 40) of the votes in the first round, the majority format is setting very high stakes. It is clear to all participants in the election that the president will generally be chosen in the second round. Consequently, the incentives to form electoral coalitions (which were prohibited in Ecuador until 1996) for the first round are rather low and parties are clearly induced to present their own presidential candidate when participating in congressional elections. After having outlined the effects of electoral rules on the party system, two other aspects of election procedures – mid-term elections and re-election – will be considered as they influence executive-legislative relations and thus also governance.

Mid-term elections. While Bolivia had four-year congressional periods (five-year since 1997) since 1985, Ecuador held biannual elections between 1984 and 1998 (four-year periods since then). Provincial deputies in Ecuador had two-year terms until 1998 and elections took place biannually thus alternating between joint presidential and congressional elections and pure elections for Congress. This led to a situation where the composition of the legislature was completely altered every two years, and the size of the ruling party[33] generally diminished radically as economic reforms undertaken usually proved unpopular. For example, during the presidency of Borja (1988-92) the representation of his ruling party, the ID, was reduced from 42.3 per cent of the seats in Congress to 19.4 per cent in the mid-term elections in 1990. Similarly Ballén's PUR counted on only 3.9 per cent of the seats in 1994, after 15.6 per cent in the first two years of his term in 1992-94 (TSE, 2005). Political analyst Simón Pachano considered the mid-term elections to be "fatal" for the continuation of policies:

"The renewal of the Congress and the national deputies in the middle of the term represented a renewal of around 85% of all deputies. That is to say practically a total change of the Congress and a total change of the composition of the Congress... This renewal, together with the prohibition of alliances, was obviously fatal for the continuation of policies. And because of this practically all governments take a U-turn in their second year and abandon their economic programme." (Pachano, interview, 18.3.2004)

[33] I will refer to the party of the president as "ruling party", irrelevant of the degree to which this party does actually "rule"...

With the constitutional reform of 1998 mid-term elections have been abolished.

Re-election of presidents and legislators. Presidents in Ecuador were only allowed to serve one four-year term during their lifetime. Since the constitutional reform of 1998, however, the rule on re-election has been weakened: presidents may be re-elected though not for two consecutive terms (Art. 98;165).[34] In Bolivia, where presidents are elected for a term of five years since 1997 (previously four), the currently valid Constitution of 1967 proscribes immediate re-election (Art. 87:I; 89:2). The arguments in favour of these restrictions are a check on presidential power, a prevention of self-perpetuation in office and of making the president concentrate on the national interest rather than on being re-elected (see Linz, 1994; Shugart and Carey, 1992). Linz suggested that the experience of lifelong non-democratic rulers played a decisive role in generating rules banning re-election. Considering that in Ecuador José Maria Velasco Ibarra dominated politics for about 40 years, between 1934 and 1972, this seems a convincing explanation. However, although providing a potential check on presidential power, restrictions on re-election can have disadvantages: in case of successful and popular presidents voters are deprived of returning them to power; and, if on the contrary voters are dissatisfied with their leaders, they do not have the possibility to hold them accountable (see Shugart and Carey, 1992). These arguments might have played a role in Ecuador's decision to weaken the restrictions on re-election.

As regards Members of Parliament, in Bolivia there are no limits on their re-election, while the Ecuadorian Constitution banned them from being re-elected immediately. They were allowed, however, to stand again after one term. In a popular consultation of 1994 it was decided to change this rule and from the 1996 election onwards, deputies have been allowed to stand for re-election in consecutive terms. The former rules basically meant that the legislature was completely renewed every two years. According to Mejía-Acosta (2002:164) in the time period when the rule was valid (1979-96) 368 deputies were elected only once, 47 twice, 11 three times, and one had been elected four times. This shows the extent to which the legislature was renewed in the biannual elections. Pachano commented on the detrimental effects of this rule on the efficiency of the Congress:

[34] The effect of this constitutional change could be observed in the presidential elections of 2002: some former officeholders – Rodrigo Borja (1988-92) and Osvaldo Hurtado (1981-84) – presented themselves as candidates.

"I think that the ban on re-election together with other regulations of the Ecuadorian electoral system produced a lot of instability in the Congress, produced fragmentation and a lack of continuity in managing the Congress and a great improvisation in terms of political leaders. By allowing the re-election there was a certain professionalisation of the deputies." (Pachano, interview, 18.3.2004)

2.7 ON COALITIONS

When analysing effects on governability, the institutionalist literature has mainly focused on variables such as the effective number of parties or the extent of presidential powers – the presence or absence of coalitions has rarely been taken into account. Probably it has not featured highly on the agenda, as the question of the capacity for coalition-building is often seen as an exclusive feature of parliamentary regimes. As Lijphart (1994:97) argued

"presidentialism is inimical to the kind of consociational promises and pacts that may be necessary in the process of democratisation and during periods of crisis, whereas the collegial nature of parliamentary executives makes them conducive to such pacts".

Other authors likewise claimed that there are few incentives for coalition-building or co-operation in presidential regimes (see, for example, Valenzuela, 1994:93). Several other authors developed a narrowed-down version of this argument: not presidentialism as such but the "difficult" combination of presidentialism and a multi-party system would lead to political instability and would lack incentives for the formation of coalitions (Mainwaring, 1993:200; see also Shugart and Carey, 1992:32-33).

Throughout the last decades coalition theory has been a thriving field of research in political science and a large body of literature on coalitions occurring in parliamentary regimes – mainly those of Western Europe – has developed. A short review of the literature shall follow here. Riker's work (1962) is generally considered as the one that started the field of coalition theory. Using a game-theoretic approach and assuming that parties are solely interested in holding office, he claimed that winning coalitions of minimum size (just about exceeding a majority) would form. This "minimum size principle" was later criticised as it was not able to explain the occurrence of minority governments or surplus majority coalitions (exceeding the majority by a wide margin). Following on from Riker's work coalition theory divided into two different streams: one continued with his game-theoretic approach which mainly uses European coalition bargaining as a means to develop game theory further (Laver & Schofield, 1990:9); the second line of research has been the 'European politics' tradition, which is grounded in empirical theory and focuses on cross-national case studies. These two different approaches have developed into two largely separate fields of research.[35] One of those who developed Riker's approach further was Dodd (1976) who contended that in fractionalised party systems winning coalitions were unlikely. While winning coalitions would occur in moderately fragmented party systems minority governments or surplus coalitions would be formed in systems with a higher degree of fragmentation.

Luebbert (1986) was concerned with variables leading to minority governments and found that they occurred both in unpolarised political systems with well-developed consensus-building mechanisms and in polarised systems where the lack of consensus-building mechanisms prevents the formation of majority governments. Luebbert's main contribution was to take intra-party politics into account and not simply regard parties as unitary actors when analysing coalition-building. Like Luebbert, Strøm (1990; 1997) looked into the factors leading to minority governments and argued that parties would avoid joining a coalition government if it would decrease its prospects of winning the elections in the future. He considered that holding office would generally damage a party's popularity more than when it was part of the opposition. Strøm thus made voters' reactions an important aspect and thereby challenged the idea that coalition formation was dependent only on intra-parliamentary constellations.

In 1983 Bogdanor's *Coalition Government in Western Europe* provided an important summary of the discussion so far and contained a collection of essays analysing coalition politics in various Western European countries. Bogdanor, whose other work has focused mainly on questions concerning electoral reform of the Westminster Model, linked this volume on coalitions to the debate regarding the introduction of proportional representation taking place in Britain at the time. In the book coalitions are approached from three angles: one looking at how constitutional aspects impact on the formation of governments, another asking how government institutions such as the cabinet, legislature or the traditional parties were affected by the coalitions, and finally analysing what difference coalitions made regarding policies introduced and how this differed from single-party governments. The essays contained in the book provide "thick descriptions" of the government formation process in Western European countries and

[35] Research undertaken in the 'European politics' tradition has been published in journals such as the *European Journal of Political Research, West European Politics,* or *Electoral Studies*. For authors in the game-theoretic tradition see, for example, Axelrod (1970), De Swaan (1973), Laver & Shepsle (1990; 1996), Schofield (1993), Crombez (1996).

represented an important contribution to the empirical – as opposed to the game theoretic – tradition of coalition theory.

In his introductory chapter, Bogdanor distinguished between three different types of coalition: governmental, parliamentary and electoral. While electoral coalitions depend on the electoral system of each country, parliamentary coalitions are defined as those where a party ruling as minority government co-operates with other parties, to pass legislation, for example. Bogdanor was mainly concerned with governmental coalitions, which he again sub-divides into three categories: a Government of National Unity would be formed by the main parties when facing a national emergency like war or an economic crisis. Secondly, a coalition government could be one in which the co-operating parties later on merge into one party. Thirdly, and most importantly for the author's purposes, there are power-sharing coalitions in which two or more parties, individually failing to secure a majority, join to form a majority government.

"Power-sharing coalitions differ from Governments of National Unity since they do not embrace –or indeed attempt to embrace – all of the parties in the political spectrum in order to implement a 'national' programme. On the contrary, they seek to implement a programme agreed between the coalition partners but probably opposed by those parties which do not belong to the coalition. This type of coalition realigns the parliamentary opposition, but does not eliminate it. Power-sharing coalitions also differ from coalitions of the second type – those which are a prelude to fusion – since there is no intention on the part of the coalition partners to surrender their separate identity. The parties comprising the coalition do not join together in an electoral pact, but continue to compete electorally with their coalition partners." (Bogdanor, 1983:12).

As Bogdanor pointed out these power-sharing coalitions tend to occur in systems of proportional representation where no party gains a majority and when the formation of majority governments – rather than minority ones – is facilitated by constitutional traditions. An important distinction for this thesis, between parliamentary and presidential regimes, is hinted at. The crucial difference between these two regime types is that in parliamentarism the formation of a coalition is usually required. Since the chief executives are elected by the parliament they need the positive vote of a majority in parliament to get into power. At the same time terms of offices are not fixed and chief executives depend on the support of the majority of the parliament for their survival. Presidentialist systems, by contrast, are defined by separate origin and separate survival (Mainwaring & Shugart, 1997:15; see also Section 2.1). Presidents do not require a majority vote of the parliament to gain office, which makes coalition-building optional rather than a necessity.

Yet there are exceptions to this rule in both regime types. In another work Bogdanor (1984) looked at the role of monarchs in constitutional monarchies of north-west Europe and their role in the government formation process. What is of interest here is his discussion of the concept of "negative parliamentarism", which means that governments do not need to be approved by the parliament. They are formed in different ways; in Denmark, for example, a round of negotiations between the Queen and party leaders takes place until a government is found which would not be met with a vote of no confidence in parliament. This system allows the existence of minority governments, which have been the norm rather than the exception in Denmark since 1945 (Bogdanor, 1984:59). Though it may be difficult to draw parallels between the case of Denmark with its co-operative political culture and other countries, it shows to what extent the formation of majority coalitions depends on constitutional rules regarding the election of the head of state in the parliament. Since this is not generally required in presidential systems, so it follows, majority coalitions do not occur with the same frequency as in parliamentary systems. This in turn highlights the crucial role of Bolivia's executive electoral formula, which could here be termed as "positive presidentialism". As in parliamentarism presidents in Bolivia require a positive vote of confidence to take office which therefore necessitates them to form majority coalitions to support their election beforehand.

While coalition-building processes are generally different from each other in parliamentary and presidential regimes, it does not follow that presidentialist systems *per se* are unable to produce coalitions. A number of scholars started to question the assumption that presidentialist regimes are not conducive to coalition-building (see Deheza, 1997, 1998; Altman, 2000; Amorim Neto, 1998, Forthcoming; Lanzaro, 2001a; Chasquetti, 2001). Most of this research has involved large statistical studies such as Cheibub et al. (2004), which has shown that presidential systems produce significant numbers of coalitions. While it seems now established that certain institutional aspects rather than presidentialism as such inhibit coalition formation, to date no conclusive theory exists about the conditions under which coalitions are formed, although a few hypotheses have been brought forward. Chasquetti (2001), for example, argued that only extreme multi-party systems would be problematic, but that moderate multi-party systems had the capacity to generate government coalitions; and Negretto (2003) maintained that coalitions are more likely when presidents lack decree powers and are subject to congressional control. These authors have started to make a contribution to coalition theory by focusing on presidential regimes, a field that will hopefully receive increased attention in the future.

Coalition-building in Ecuador and Bolivia. As outlined in Chapter 1.2., several Bolivian scholars – predominantly Gamarra and Mayorga – have established a link between constitutional provisions concerning the election of presidents in congress and the formation of inter-party coalitions. A large number of interviewees in Ecuador have stated that the second round majority run-off elections for the president had a detrimental effect on governability, as it created a situation whereby presidential parties have only a small representation in Congress (see Chapter 8.1). It seems therefore that the variation in the executive electoral formula influences a regime's capacity to generate coalitions. Regarding Ecuador, other institutional aspects present further disincentives to inter-party cooperation: the biannual midterm elections to Congress in place until 1998 meant that parties were in an almost permanent election campaign, a situation during which parties are usually unwilling to tie themselves to a president. Midterm elections also meant that the composition of Congress changed every two years, thereby practically ruling out the possibility to build coalitions for a full presidential term. As pointed out in Section 2.5, Ecuadorian legislators do not display a high degree of party discipline, as comparatively large numbers disaffiliate from their parties; this situation of party-switching also impedes the creation of stable coalitions.[36]

Looking at coalition formation in Ecuador and Bolivia during the last two decades, Ecuador had only few cases of inter-party coalitions, and all but one were minority coalitions. During the government of Febres Cordero, it was the opposition that was able to form a coalition, the *Bloque Progresista.* The most explicit example of a government coalition[37] has been the one crafted by President Borja. On coming to power in 1988 he built a majority coalition between his own party (ID – *Izquierda Democrática*) and the DP (*Democracia Popular*). At the end of 1989, however, the DP left the government. Coalitions in Ecuador have been rather a rarity and if formed at all, they have been fragile and short-lived. Presidents usually tried to build ad-hoc coalitions for every reform they planned to introduce. As argued by Mejía (2000; 2002) though Ecuadorian presidents failed to form stable coalitions, they often managed to form

[36] The question of why coalitions were possible in Bolivia and not in Ecuador will be discussed more extensively in Chapter 8.2.

[37] I will follow the definition provided by Cheibub et al. (2004), who distinguished between government coalitions which involve a set of legislators belonging to parties that hold cabinet posts, and legislative coalitions in which legislators from different parties vote together. For the purposes here, I am interested in the existence of government coalitions which are also legislative coalitions.

alliances around certain legislative initiatives, which were achieved by *"some informal mechanisms (like sponsoring independent deputies or sponsoring party defections)"* (2000:15). Members of these alliances would typically not admit their support of the government publicly (2000:13).

Bolivia, however, challenges the aforementioned claim that presidentialist systems with a multi-party system are unable to produce coalitions. Ever since the *Pacto por la Democracia* (Pact for Democracy) between Paz Estenssoro's MNR and Banzer's ADN in 1985, coalitions were formed at the government level and a stable pattern of coalition-building emerged: between 1989–1993 ADN and MIR formed the *Acuerdo Patriótico* (Patriotic Accord); in the following four years president Sánchez de Lozada's party governed in coalition with both the *Unión Cívica Solidaridad* (UCS) and the *Movimiento Bolivia Libre* (MBL); in 1997 Banzer's ruling party ADN entered a coalition with three other parties, UCS, MIR and CONDEPA (*Conciencia de Patria*); and the last coalition – though rather fragile – consisted of the ruling MNR, MIR and later on also NFR between 2002–03.[38]

In sum, the literature on coalition formation has almost exclusively focused on parliamentary regimes in Western Europe, though some work has now been started on coalitions in presidential systems. The literature on presidential regimes has so far largely ignored the aspect of coalition formation and its influence on governability. As will be seen in this thesis, however, the capacity of a system to produce coalitions has frequently made a crucial difference to presidents' abilities to introduce policies.

2.8 Relating Political Structures and Economic Reforms

This chapter has outlined the political systems of Ecuador and Bolivia, their respective regime types, constitutional powers, legislative processes, electoral procedures, the party systems and coalition formation were analysed. The study will now relate this politico-institutional analysis to economic policy-making in Ecuador and Bolivia during the last two decades.

The debate on economic reform processes in Latin America has often focused on regime type and on the question whether authoritarian or democratic regime types are better suited to implement economic reforms. This discussion bears some similarity to the presidential-parliamentary debate as it also focuses on broad regime types, on

[38] For more information on these coalitions see Chapters 4 and 5.

democracy as such rather than a specific form of democracy. Ecuador and Bolivia have experienced different patterns of governance and economic policy-making processes. Given that they are of the same regime type, this broad concept is unable to account for their differences. Consequently, it can be argued the analysis should take into account the specific elements of political systems. Ecuador and Bolivia have implemented economic reforms to varying degrees during the 1980s and 1990s. Bolivia was one of the earliest cases to implement market-oriented reforms in Latin America, it carried out wide-ranging structural reforms from 1985. Ecuador, on the other hand, has followed a much more gradual approach and structural reforms were often piecemeal ever since the first attempt at stabilisation in 1982. Clearly it is a combination of factors that has led to these variations. While taking other variables into account the specific question to be investigated in this study is: to what extent have institutional aspects of the political systems of Ecuador and Bolivia influenced economic policy-making? In the following I will outline several hypotheses that will be examined in the study. They have developed out of the preceding analyses of the political systems of Ecuador and Bolivia.

Hypotheses.

Constitutional powers. When considering constitutional powers of presidents and congress in Ecuador and Bolivia, we have seen that Bolivia can be considered as having a rather "weak" executive in terms of presidents' constitutional legislative powers, while Ecuadorian presidents are granted rather extensive powers. Did the differences between powers granted to the president and the legislature influence the successful implementation of economic reforms? Did "weak" presidencies in Bolivia and "strong" presidencies in Ecuador lead to differences in economic policy-making? Given that Bolivia during the 1980s and 1990s generally introduced economic reforms much earlier, more comprehensively and consistently than Ecuador it seems that extensive powers did not facilitate the introduction of reforms. For the analysis of tax reforms to follow, it is thus assumed that

⇒ the degree of constitutional powers is of limited importance for presidents' abilities to introduce reforms "successfully".[39]

On coalition-building. While Bolivia has developed a pattern of coalition-building ever since the *Pacto por la Democracia* between Paz Estenssoro's MNR and Banzer's ADN

[39] When using the term "successful", I do not intend to imply any judgement or endorsement of the policies themselves. Successful here simply refers the ability to introduce and maintain economic reforms as proposed by the executive.

in 1985 and up until 2003, the Ecuadorian governments have been able to form very fragile and short-lived coalitions only, if at all. How have these patterns affected economic policy-making? The following hypotheses will be analysed:

⇒ Ecuador's multi-party system has been inimical to governing effectively and to implementing economic reforms due to the system's lack of ability to produce effective coalitions.

⇒ Bolivia's multi-party system has allowed presidents to successfully implement economic policies in the 1980s and 1990s due to its capacity to generate stable governing coalitions. The country's particular form of "parliamentarised presidentialism", in which presidents are elected by Congress in the second round election, has provided an institutional incentive for coalition-building.

Breakdown of coalition politics. While Bolivia has experienced a period of political stability for almost two decades from 1985 onwards and while presidents have been able to introduce the reforms basically as proposed by them, this pattern has come to an end in recent years. Starting from around 2000 street protest gained more and more momentum and governing via coalitions became increasingly difficult. The end of this period of stability was most markedly expressed by the forced resignation of Sánchez de Lozada in October 2003, which had followed weeks of state-society conflicts during which around 60 people died. The presidential successor, Carlos Mesa (2003-05), governed by breaking away from the old pattern of forming coalitions, trying to distance himself from the discredited traditional parties. Since he thus did not count on any allies in the legislature introducing economic policies was generally difficult for Mesa. In June 2005 he resigned in an attempt to facilitate a way out of the deadlock in state-society relations. He was succeeded by Eduardo Rodríguez, head of the Supreme Court, after the presidents of both the lower and the upper chamber had waived their right to take power. Given this contrast between the experiences of the last years and the post-1985 period, an explanation for the breakdown of coalition politics and the resurgence of extra-institutional politics will be attempted in a third step. The question to be addressed is: why did the same institutional arrangements that allowed for the introduction of economic reforms and democratic stability during the 1980s and 1990s lead to political instability and presidential failure to introduce economic reforms (or to stay in power) in recent years?

3 Patterns of Economic Reforms

It is a common view that Bolivia was a radical reformer during the 1980s and 1990s, a *"showcase"* (Mayorga, 1997:143) implementing policies of economic liberalisation basically overnight, while Ecuador is usually considered as one of the main laggards of the region, a country *"muddling towards adjustment"* (Grindle, 1993). However, this assessment is often made on the basis of a broad and general overview of the economic reform processes of the two countries only. It is probable that the processes differ depending on the type of policy, and it is likely that the various economic reforms – such as trade liberalisation, tax reform, public sector reform etc. – have been implemented to different degrees in both countries. It may be possible that in some policy areas, Ecuador even started the reform process earlier, or implemented more comprehensive reforms than Bolivia. In order to get a more differentiated view on the patterns of economic policy-making it is necessary to move away from a broad analysis and from individual studies of the two countries.

The previous chapter offered an analysis of the extent to which the political structures of Ecuador and Bolivia differ, in their presidential systems, constitutional powers, electoral rules and party systems. Following from these politico-institutional aspects, this chapter will analyse the so-called *Washington Consensus* reforms introduced in the two countries during the last two decades. This will put tax policy-making into context by showing what else happened in Ecuador and Bolivia regarding economic reforms. The analysis makes clear that tax reform is representative for the dynamics of other policy areas. Before looking at these different economic reforms a short discussion of the *Washington Consensus* concept shall follow.

The origin of the *Washington Consensus* can be traced back to a conference organised by the Institute for International Economics in Washington in 1989. Representatives of the multilateral organisations and of Washington-based think tanks as well as Latin American policy-makers had come together to evaluate the economic reforms introduced in the region during the 1980s. As a result of the conference John Williamson produced a list of ten policy reforms: fiscal discipline, public expenditure priorities in education and health, tax reform, financial liberalisation, competitive exchange rates, trade liberalisation; openness to foreign direct investment, privatisation, deregulation, and protection of property rights (Williamson 1990 a+b). Compiling this list was an act he considered as documenting the policy process that was already happening in Latin America anyway and of which Washington was largely unaware (Williamson, 1997:48). If this was his intention the subsequent discussion certainly frequently did not understand the list as policy documentation but rather as a policy manifesto. In 2002 Moisés Naím stated that the *Washington Consensus* had become *"a damaged brand name"* (FT, 28/10/2002). Criticism of the concept took mainly two directions as was summarised by Frances Stewart (1997:62):

"The debate about the Washington consensus *(WC) is a debate about process – who makes policy, the legitimacy of the process and the right to freedom of thought. It is also a debate about content – whether the contents of the WC are right in themselves for ever, for all countries, for all times, sufficient or necessary conditions of development, and so on."*

The fact that "Washington" was part of the term chosen by Williamson led to the criticism that these policies were chosen by Washington-based organisations and imposed on Latin American countries. Because *Washington Consensus* policies could often be found in the conditionality attached to the loans given to Latin American countries by the IMF and the World Bank also fuelled this discussion. When Joseph Stiglitz developed a *"Post-Washington Consensus"* in 1998 he reflected this debate and claimed that policies can only be sustainable when countries choose and take ownership of them and that a revised consensus could therefore not be based on Washington (Stiglitz, 1998:33). The second major area of contention was the individual policies proposed. During the 1990s it became increasingly clear that the *Washington Consensus* did not deliver the expected results. Especially when comparing the economic results achieved in Latin America to those of East Asian countries, the *Washington Consensus* "recipe" seemed to be called into question. In response to the growing criticism several authors have developed a revised version of the Washington Consensus. Naím (1994) was the first to point out that Latin America was entering a second stage of reforms and that the policy agenda should turn to the previously neglected area of public sector institution building.[40] This second phase of reforms was later extended to include distributive measures, as income inequality had been on the rise since the onset of the first generation reforms (i.e. *Washington Consensus*). The second generation reforms were generally seen as complementing the *Washington Consensus* not replacing it.

[40] See also Naím (2000), Burki and Perry (1998), Rodrik (2002).

Williamson (1997; 2000; Williamson & Kuczynski 2003) himself admitted that there had been some flaws in the original *Washington Consensus* and he pointed out especially the recommendation concerning financial liberalisation and the exchange rate. In the revised agenda he took on Naím's concern for institution building and called for more focus on the education sector by improving spending on primary and secondary levels (Williamson, 1997:56-57). In the course of the ongoing discussion all kinds of revised versions of the *Washington Consensus* were discussed and the agenda became more and more confused. In part this can be interpreted as an acknowledgement that the straightforward policy agenda of the original *Washington Consensus* has not worked and that the international community is currently far from reaching a consensus on the policies required at this point.

For the purposes of this chapter I am borrowing from Williamson's original list of ten reform areas. The intention is not to endorse this agenda but simply to use it as a framework for evaluating to what extent reforms have been introduced in Ecuador and Bolivia since the 1980s. Though some advances have been made, second generation reforms largely remain to be introduced as there is a need for reforming public sector institutions and as high income inequality exists in both countries. [41] Using the *Washington Consensus* as a framework and adjusting it to mirror the reforms that have been introduced in Ecuador and Bolivia the areas considered are: 1) Public Expenditure Priorities; 2) Tax Reform; Fiscal Discipline[42]; 3) Trade Liberalisation; 4) Financial Liberalisation; 5) Exchange Rate; 6) Foreign Direct Investment; 7) Privatisation; 8) Social Security. In a final section other areas playing a crucial role in the economies of Bolivia and Ecuador are considered: Foreign Debt; Hydrocarbons; Foreign Aid; Coca. Rather than comparing the introduction of reforms in these areas, they are included here to give an overview of crucial elements of both Ecuador's and Bolivia's economies.

3.1 Public Expenditure Priorities

Bolivia. Before switching to a market-oriented model in the mid-1980s Bolivia had followed a model of state capitalism, with the state playing a leading role both in investment and employment. Especially during the period of Banzer's government

[41] As regards taxation, an exception is that both countries have taken measures to institutionalise their internal revenue services in recent years.

[42] Fiscal discipline is included mainly to inform about the fiscal balance. Since taxation and government expenditure are the two instruments of fiscal policy, the related policies are outlined in these sections. Fiscal balance is therefore not considered as a separate policy area.

(1971-78) the role of the state was expanded, it invested heavily in social and economic infrastructure. Prior to 1985, with the exception of Cuba, Bolivia had the highest share of its economically active population employed by the public sector in the region (Morales, 1994:138). During the government of General Banzer the number of public sector employees grew enormously: while in 1970 there were about 66,000 employees, 177,000 people were employed in the public sector in 1978 (World Bank, 2000a:1) and 245,379 in 1985 (Morales, 1996:42). As most other countries of the region, Bolivia had also implemented price controls and a comprehensive system of subsidisation during that time.

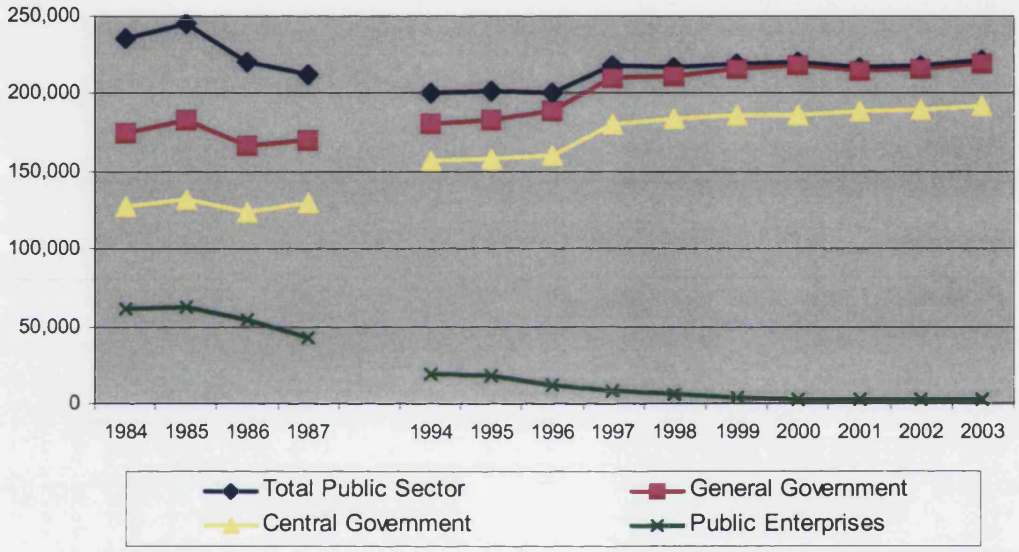
Subsidies. Facing a situation of increasing fiscal deficits and no access to capital inflows in the post-1982 period, some first attempts at reducing subsidies were made during the years before 1985 as President Siles Zuazo (1982-85) increased prices for basic foodstuffs and petroleum several times during his government. These measures, however, had little impact on the still very high degree of subsidisation which, for example, allowed Bolivian citizens in 1984 to pay transport fares which were about one-tenth of the price in a competitive market (Cariaga, 1990:46). In 1985, then, the famous *Decree 21060* eliminated state subsidies (of foodstuffs, petrol, and public transport) practically over night. In consequence, petrol prices, for example, rose from US$0.3 cent per litre to 0.30 (Lynch, 1994a:105). Food stores run by the government and offering highly subsidised products were closed. Some relics of the subsidisation scheme were, however, still in place in 2002: for example, bottled liquid petroleum gas – used by most Bolivian households for cooking and heating – continues to be subsidised. Attempts at completely abolishing this subsidy were made but then postponed by the government due to strong opposition.

Public sector employment. The *New Economic Policy* (NEP) aimed at reducing the number of public employees in order to cut public expenditures. One of the main measures was the closing of unproductive state mines in 1985, which led to the dismissal of around 20,000 miners (Lynch, 1994a:106).[43] Since the early 1990s employment in state-owned enterprises was further reduced (naturally so since some of them were sold), yet presidents still failed to reduce the number of employees at government level. According to some estimates around 20,000 new employees were

[43] Until 1985, when world market prices collapsed, tin had been Bolivia's major export product. In the aftermath of this collapse, however, almost all tin mines started to make huge losses. Above all Comibol, the state mining corporation, became hugely unprofitable and added around US$720m to the public deficit between 1981 and 1985 (EIU, Bolivia, 1994-95:18).

hired during the first two years of the Paz Zamora (1989-93) government (Gamarra, 1994:115). Public sector employment had peaked at 245,600 in 1985 and was downsized to 200,918 by 1996 (see Figure 3.1). The reduction was only due to a cut by around 50,000 people – from 62,500 to 12,078 – employed in the public enterprises, however. As regards general government level the number of employees gradually increased and exceeded 200,000 by 1997; similarly between 1987 and 1997 central government employment rose by 50,000 positions, from 129,300 to 180,470. In recent years the trend has continued.

Figure 3.1: Public Sector Employment, Bolivia



** Note: No data available for the years 1988 – 1993.*

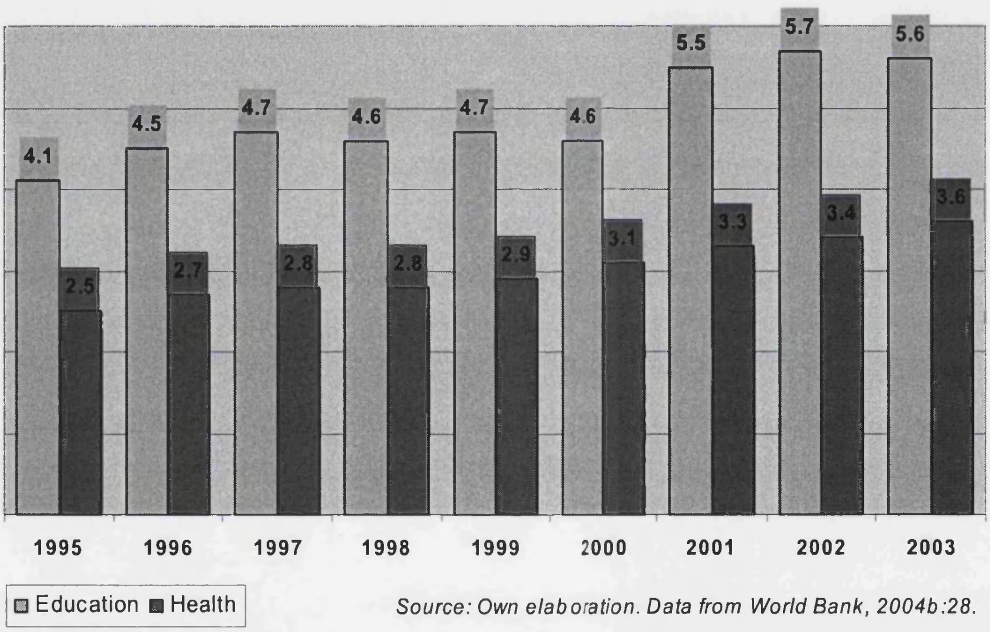
*** Total Public Sector: includes general government and public enterprises; General Government: includes consolidated central government and all units of the subnational authority; Central Government: includes all units representing the territorial jurisdiction of the central authority throughout a country, together with all other ministries and administrative departments, including autonomous agencies.*

Source: Own elaboration. Data for 1980 to 1987 from CLAD (2004); 1994 to 1997 from IMF (2000a:23); 1998 to 2003 from World Bank (2004b:19)).

In Bolivia salary expenditures on the combined public sector represented 6.8 per cent of GDP in 1990, then climbed to 8.3 in 1995 and in 2001 were 8.8 per cent (World Bank, 1999:10; 2004b:3). These developments are in clear contradiction to the objective of Bolivia's NEP to reduce public spending and represent a contrast to the country's otherwise radical pursuit of *Washington Consensus* reforms. It seems likely that the existence of patronage politics caused this pattern: it was easier for the government to dismiss employees in state industry than to dismiss those in public administration, as these positions were necessary for political bargaining with other parties in coalition-making. According to Gamarra (1994:122): *"a central dynamic of politics has always been to circulate the commodity of government positions (*cargos, puestos, y pegas*) among the dependent middle class which does not control hard sources of wealth on its own."*

Health and education. During the first two years of Bolivia's new economic model, social expenditure (as percentage of GDP) was reduced considerably. Large cuts were made in the education sector: there was a decline from 3.3 per cent of GDP in 1985 to 2.3 per cent in 1986 (Morales, 1994:140). Yet, as Figure 3.2 shows, by 1995 spending had climbed again to 4.1 per cent of GDP, and gradually increased reaching 5.7 per cent in 2002. In parallel, funding for the health sector equally increased: while it had been 2.5 per cent in 1995, it was 3.6 per cent of GDP in 2003.

Figure 3.2: Public Expenditures on Education and Health (% of GDP), Bolivia*



Source: Own elaboration. Data from World Bank, 2004b:28.

Williamson (1990a+b) defined the *Washington Consensus* on public sector expenditures as reducing public spending and shifting priority from public administration, the military and subsidies to greater priority of the social sector. Bolivia fulfilled these aims as subsidies have been abolished and spending on health and education has increased. However, no significant inroads have been made to reduce public sector employment.

Ecuador. Compared to other countries of the region Ecuador was a late industrialiser. During the first decades after World War II the state did not play any significant role in the national economy as coastal-based agricultural exports such as cocoa and bananas were under the sole control of private entrepreneurs. The situation began to change radically when oil was discovered and exporting began in 1972. During the 1970s military governments made substantial changes to the Ecuadorian economic model: the number of state-owned enterprises increased dramatically – by means of a nationalisation process of industries such as steel, the takeover of the national airline and other firms, and the gradual nationalisation of the petroleum industry. Secondly, costly subsidy schemes, mainly targeted at consumer durables, were implemented during this period. From the early 1970s, prices for petrol and electricity were among the lowest world-wide (Grindle, 1993:130) and by 1978 the government spent almost 50 per cent of its budget on financing subsidies on oil, credits, and basic foodstuffs (Corkill and Cubitt, 1988:33). In addition, the size of the public administration increased substantially during the 1970s, between 1972 and 1977 alone 40,000 new public employees were taken into service (Isaacs, 1993:57).

Subsidies. With the onset of introducing market-oriented reforms in Ecuador in the 1980s, governments started to gradually remove those subsidisation schemes. The government of Hurtado (1981-84) was the first to reduce subsidies and to raise petrol prices by 120 per cent. All following governments undertook similar steps to lower their spending on subsidies though often they had to reverse or modify these measures given the extent of opposition they faced (for example, Hurtado in 1982, Bucaram and Alarcón in 1997; Mahuad in 1998). Domestic fuel prices, which had been gradually increased since the early 1980s, finally came close to those of the world market by April 1992 (EIU, Ecuador, 1992-93:19)[44]. As regards energy subsidies until 1999 they covered approximately 70 per cent of the consumer electrical bill (Nazmi, 2001:729). Cooking gas has remained to be state-subsidised and proved extremely difficult for presidents to eliminate given the level of societal resistance. In late December 2000, for example, the government of Noboa announced a 100 per cent increase in the price of cooking gas. Due to massive protests mainly by indigenous movements, the president made some concessions and reduced the price increase to 60 per cent only (Beckerman and Cortés, 2002:106ff.). Economic analyst Alberto Acosta maintained:

"The society's attention has centred on the gas in an almost religious way. It is like the last memory of the petrol bonanza. The people say this is our gas, at least the gas we will buy cheap." (Acosta, interview, 23.3.2004)

[44] The Economist Intelligence Unit (EIU), Country Profile: Ecuador. 1992-93:19. Throughout the text referred to as EIU, Ecuador/Bolivia (country only named in chapters where countries are compared), No./Year (if only year is given = Country Profile; if month/number and year = Country Report).

In 2002 Ecuador spent around US$110 million on the cooking gas subsidy (Crespo, 2002:5). Since the early 1980s Ecuador has introduced almost annual price increases thus gradually reducing subsidisation.

Public sector employment. In particular during the 1970s the levels of public sector employment grew significantly as the large increase in petroleum revenues triggered a surge in government spending. According to some estimates public sector employment doubled between 1972 and 1980 (see Table 3.3). Numbers continued to grow during the following two decades and stood at a level of 357,000 employees in 1997. Some of this growth, however, is natural as population growth is generally accompanied by an increase of employment in certain public sectors such as education and health. In central government, some progress has been made in reducing the number of public employees during the 1990s: this number declined from 184,000 in 1994 to 129,000 by 2000. This downward trend of the 1990s has been reversed in recent years as central government employment rose by 7.3 per cent between 2002 and 2004 (World Bank, 2004a:19).[45]

Table 3.3: Public Employment, Ecuador I

Year	Total Public Employment
1972	96,709
1980	203,635
1986	323,000
1997	357,000

Source: Araujo, 1998:6 (for 1972, 1980); Salgado and Santos 1998:24 (for 1986, 1997)

Considering the government's expenditure on wages and salaries, it becomes obvious that Ecuador has not followed a clear pattern, however: during the government of Febres Cordero salary expenses of the combined public sector tripled from 3.3 per cent of GDP in 1984 to 9.2 per cent in 1987 as he undertook large public sector hirings. In the following years this level was reduced again and remained at 7.0 to 7.9 per cent between 1988 and 1997 (Salgado and Santos, 1998:75,77). Again, in the last few years the amount spent on wages has been on the rise as the wage bill for central government employees in 2004 was projected to be 18 per cent higher than in 2002 (World Bank, 2004a:20). In short, Ecuador has made some progress in reducing the number of central government employees and expenditures on

Table 3.4: Public Employment, Ecuador II

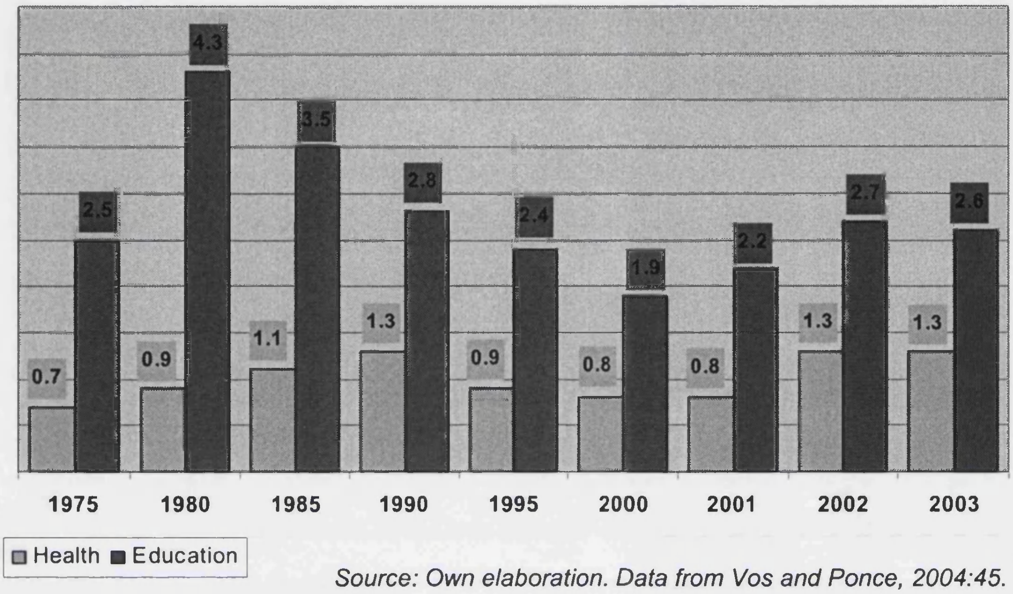
Year	Civilian Central Government
1994	184,000
2000	129,000

Source: World Bank, 2005.

[45] Note that data on public sector employment numbers is extremely limited. Within Ecuador no institution has been gathering this information.

personnel during the 1990s. However, Ecuador has not followed a consistent line: spending and employment levels were hugely increased during the mid-1980s and have again been on the rise during the last years.

Figure 3.5: Public Social Expenditures (% of GDP), Ecuador



Source: Own elaboration. Data from Vos and Ponce, 2004:45.

Health and education. During the second half of the 1970s health and education spending was boosted; spending on the education sector reached 4.3 per cent of GDP in 1980, but thereafter gradually declined to 2.8 per cent in 1990, 2.6 per cent in 2003 (see Table 3.5). Notably, the Ecuadorian Constitution contains the requirement that at least 30 per cent of central government income is to be spent on education and the eradication of illiteracy (Art. 71).[46] The Ecuadorian government has never met this target though: government spending on the education sector ranged between 16.7 and 24.8 per cent during the years 1986 to 1995 (Van Dijck, 1998:52); in 2004 it was 12 per cent (EIU, Ecuador, 2005:19). The health sector received rather low funding: the level of expenditures ranged 0.9 per cent in 1995 to 1.3 per cent in 2003. These levels are among the lowest of the region. Salgado and Santos reported that in 1995 the monthly spending on health per person equalled the price of three soft drinks (Salgado and Santos, 1998:15).

Considering these developments it becomes evident that Ecuador's public spending priorities have not been restructured in accordance with the *Washington Consensus*

[46] Constitución Política de la República de Ecuador, 1984. The subsequent Constitution of 1996 contains the same clause in Art. 96, as does the current one (1998; Art.71).

approach: although subsidies have been reduced gradually and cuts have been made in public administration, these measures apparently have not been accompanied by an increase in public spending on health and education.

Table 3.6: Public Expenditure Priorities: Bolivia + Ecuador

	1985 1990 1995 2000 2005
Bolivia	• Subsidies on consumer goods abolished ⇒ Health and education expenditure increased ⇒ Increase in number of public sector employees
Ecuador	⇒ Subsidies on consumer goods gradually reduced, annual cuts ⇒ Increase in number of public sector employees; decrease in the 1990s ⇒ Health and education expenditures not increased

Source: Own elaboration.

3.2 Tax Reform

Bolivia. Prior to the beginning of the economic reform process Bolivia had a tax system in place of which the main elements were export and import taxes. In 1973 a sales tax of 5 per cent was introduced but since more and more exemptions were added to it over the years and enforcement was low, it provided very little revenue. The Personal Income Tax was levied at a progressive rate, with the highest rate being 50 per cent; an "Enterprise Tax" was charged at a 30 per cent flat rate (20 per cent for state companies). The tax system additionally featured several hundred different taxes many of them earmarked to benefit particular groups and organisations, trade unions or universities (Bird, 1992; Mann, 1990; Cabezas, 1990).

"Prior to the Law 843 (1986, SL)*, the country's tax system was creating one tax, another tax, a little tax here, another little tax there – which eventually turned unmanageable both for the administration and the taxpayer as you did not even know all the taxes you were supposed to pay."* (Velasco, interview, 27.5.2004)

Due to the complexity of the system tax evasion was high even for South American standards and tax revenues were rather low. In 1976 a fiscal mission (sponsored by the Harvard Law School) led by Richard Musgrave visited Bolivia to evaluate the Bolivian tax system. In their report they pointed to the high dependence on taxes on foreign trade which created a high instability and Musgrave made a number of recommendations on how to improve domestic tax revenues. These proposals were not taken up by the Bolivian government, however, and during the years to follow the tax base eroded dramatically: while in 1980 total tax revenues had been 9.69 per cent of GDP, by 1984 it merely was 1.8 per cent (see Table 3.7). During the period of hyperinflation in 1984-85, the tax base all but collapsed as taxpayers would pay their taxes as late as possible thus reducing the value of the taxes paid when finally received by the government. By mid-1985 tax revenues covered only 15 per cent of government spending (Lynch, 1994a:103).

Table 3.7: Tax Revenues (% of GDP), Bolivia[47]

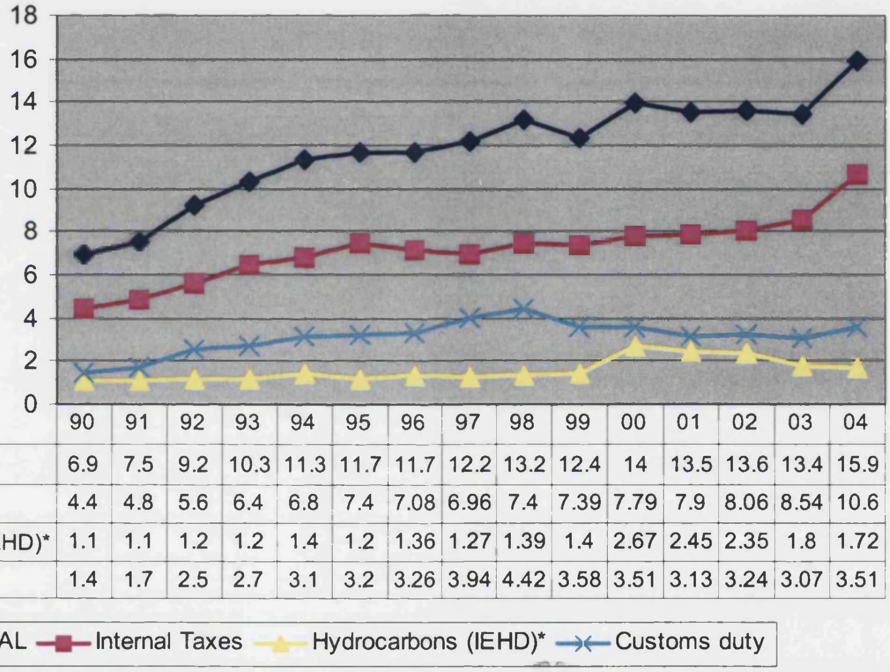
1980s[48]

1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
9.69	9.11	4.69	3.09	1.84	2.32	5.14	7.11	7.27	6.44

Source: Cariaga, 1997:33,117.

1990s

Source: Servicio de Impuestos Internos (SIN). Own elaboration.



	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04
TOTAL	6.9	7.5	9.2	10.3	11.3	11.7	11.7	12.2	13.2	12.4	14	13.5	13.6	13.4	15.9
Internal Taxes	4.4	4.8	5.6	6.4	6.8	7.4	7.08	6.96	7.4	7.39	7.79	7.9	8.06	8.54	10.6
Hydrocarbons (IEHD)*	1.1	1.1	1.2	1.2	1.4	1.2	1.36	1.27	1.39	1.4	2.67	2.45	2.35	1.8	1.72
Customs duty	1.4	1.7	2.5	2.7	3.1	3.2	3.26	3.94	4.42	3.58	3.51	3.13	3.24	3.07	3.51

** Since the privatisation of YBFB refineries, the collection of taxes via the concept of IEHD are included.*

In May 1986 the government of Paz Estenssoro completely overhauled the tax system and replaced hundreds of taxes by less than ten, mainly charged on wealth and

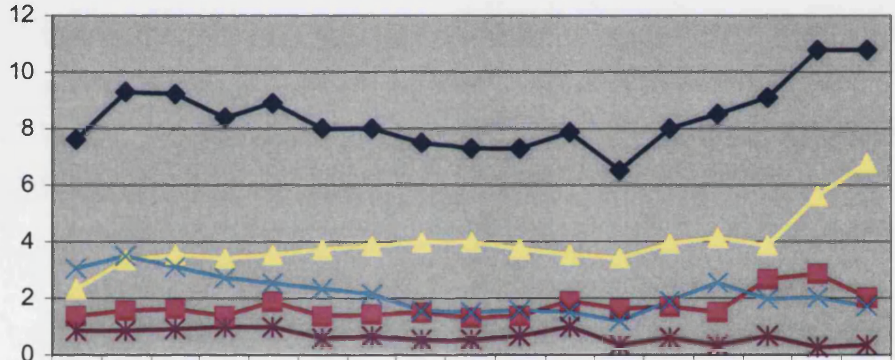
[47] Please note that there is a significant inconsistency between the total revenues (as % of GDP) given for Bolivia in this table and for Ecuador in Table 3.8 and the figures given in Table 1.2 based on data provided by Tanzi (2003). It has not been possible to determine what caused the differences and given the scarcity of data on taxation in Ecuador and Bolivia finding matching figures is next to impossible. The trends indicated in all tables used here are the same, however.

[48] According to the Internal Revenue Service (SIN) tax/GDP figures of the 1980s are rather unreliable and the SIN itself does not have this data.

consumption. A 10% VAT with hardly any exemptions was the central element, which would not only ensure a broad tax base but also enormously facilitate the procedure of tax collection. Income taxes in the traditional sense were abolished and a 10 per cent withholding tax on all income was introduced. These reforms showed considerable effect: internal tax revenues increased from 2.32 per cent of GDP in 1985 to 7.11 per cent in 1987 (see Table 3.7). After this complete redesign of the Bolivian tax system in 1986, the system was again modified in 1992, when VAT was increased from 10 to 13 per cent. In 1995 a uniform Corporate Income Tax of 25 per cent was introduced; an attempt to implement a Personal Income Tax in 2003 failed; and in 2004 a Financial Transactions Tax was introduced. Tax revenues exceeded ten per cent in 1993, and in 2003 represented 13 per cent of GDP (see Table 3.7).

Figure 3.8: Tax Revenues (% of GDP), Ecuador 1985-2001*

Source: Own elaboration. Data from BCE.



	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01
Total	7.6	9.3	9.2	8.4	8.9	8	8	7.5	7.3	7.3	7.9	6.5	8	8.5	9.1	11	11
Income Tax	1.4	1.6	1.6	1.3	1.9	1.4	1.4	1.5	1.3	1.4	1.9	1.6	1.7	1.5	2.7	2.9	2
VAT + Excise Tax	2.3	3.4	3.6	3.4	3.6	3.7	3.9	4	4	3.7	3.6	3.4	3.9	4.1	3.8	5.6	6.8
Customs Duty	3.1	3.5	3.1	2.7	2.5	2.3	2.1	1.5	1.5	1.6	1.5	1.1	1.9	2.5	1.9	2	1.7
Others	0.8	0.9	0.9	1	1	0.6	0.6	0.5	0.5	0.6	1	0.3	0.6	0.4	0.7	0.3	0.3

Total — Income Tax — VAT + Excise Tax — Customs Duty — Others

** Does not include contributions of petroleum sector.*

Ecuador. When in 1989 a tax reform was introduced, it was the first time in decades that a major overhaul of the system was undertaken. The tax structure in place had been marked by policies introduced during the 1960s and 1970s: the government of Arosemana (1961–1963) introduced a Corporate Income Tax, which was complemented by a Personal Income Tax in 1963 under the military junta government (1963-66). The Ecuadorian tax system had featured a huge number of small taxes the revenues of which went directly to various public institutions. The military junta made some progress in simplifying the tax system as it abolished hundreds of taxes (Schodt, 1987:83). A further change was made in 1970 under Ibarra (1968-72) who introduced a uniform Sales Tax. With the onset of the oil bonanza the traditional tax base suffered considerable erosion during the 1970s. When the oil boom came to an end and oil prices went down in the early 1980s tax revenues were lower than they had been in the early 1970s. Throughout the decades prior to the 1980s Ecuador's tax system relied mainly on direct taxes, as was the case in the whole of Latin America.

Table 3.9: Tax Reforms: Bolivia + Ecuador

	1985 1990 1995 2000 2005
Bolivia	• Tax reform: - hundreds of taxes abolished; - 10% VAT + Complementary Tax introduced • VAT increase to 13% • Introduction of Corporate Income Tax • Financial Transactions Tax introduced
Ecuador	• Tax reform: - simplification of tax system; - income tax of 25%; VAT 10% • 1% Financial Transactions Tax ⇒ abolished • Income taxes abolished ⇒ reinstated • VAT: 12% ⇒ 14% ⇒ 12%

Source: Own elaboration.

A tax reform of 1989 represented the first major restructuring of the system – which was still marked by a large number of different taxes, a long list of exemptions, and often rather high rates (for example, the maximum rate of income tax was 60 per cent) – in decades. Income tax (both personal and corporate) was cut to a maximum of 25 per cent and a VAT of 10 per cent replaced the turnover tax.[49] People earning less then 2.5 times the January minimum wage were exempt from income tax (EIU, Ecuador, No.1, 1990). The tax reform also included provisions to facilitate collection by simplifying the bureaucratic procedures, establishing additional collection points and, substantially increasing penalties for tax evaders. With this reform indirect taxes such as the Value-added Tax became crucial. By 1998 direct taxes contributed 33 per cent to Ecuador's

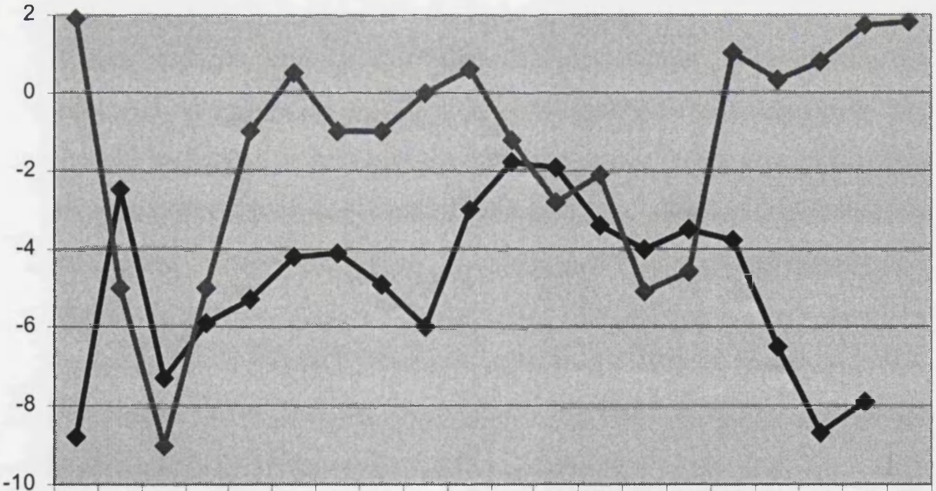
[49] The VAT is levied at every stage of production and is included in the price of the product (so when buying the product one sees a single price and does not pay the tax separately); the Sales Tax (or turnover tax) is levied only once and the percentage of the sales tax is added to the price of the product (it is thus more visible than the VAT).

tax revenues and indirect taxes 67 per cent (Salgado and Santos, 1998:17). Tax revenues (excluding revenues from the petroleum sector) represented between 7 and 9 per cent of GDP during the 1990s and were 10.8 per cent in 2001 (see Table 3.8).

Fiscal Discipline

Bolivia. Throughout the 1970s the public deficit had been growing in Bolivia and reached unsustainable levels at the beginning of the 1980s. The combination of very low government income and high levels of public expenditures on state enterprises and subsidies, led to a deterioration of public finances. Given that Bolivia, as basically the rest of South America, faced a cut-off from international loans in the aftermath of Mexico's 1982 debt crisis, the budget deficit had to be financed in a different way. The Bolivian government of that time mainly took recourse to the printing press. Essentially this led to the situation of hyperinflation peaking at 11,749.6 per cent in 1985 (see Appendix D). With the help of structural policies introduced in 1985 the fiscal deficit fell to 2.5 per cent (of GDP) in 1986, before rising again to 7.3 per cent (of GDP) in 1987 (see Figure 3.10).[50]

Figure 3.10: Non-financial Public Sector Balance (% of GDP), Bolivia + Ecuador



	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04
Bolivia	-8.8	-2.5	-7.3	-5.9	-5.3	-4.2	-4.1	-4.9	-6	-3	-1.8	-1.9	-3.4	-4	-3.5	-3.8	-6.5	-8.7	-7.9	
Ecuador	1.9	-5	-9	-5	-1	0.5	-1	-1	0	0.6	-1.2	-2.8	-2.1	-5.1	-4.6	1	0.3	0.8	1.7	1.8

Source: Own elaboration. Data for Bolivia from EIU, 1995-96:30 (for 1985-92); 1998-99:32 (for 1993-94); 2001:42 (for 1995-98); 2004:39 (for 1999-2003). For Ecuador: World Bank, 2004a:ii.

[50] This increase in 1987 was mainly caused by external shocks: as mentioned in 1985 world market tin prices declined substantially; additionally, Argentina (from whom Bolivia received 40% of its export earnings) did not settle all payments for natural gas imports (Cariaga, 1990:45).

Due to continued structural reforms, such as further tax reform or the increased withdrawal of the state in production, the non-financial public sector deficit was gradually reduced and reached a level of 1.8 per cent in 1995. In subsequent years the deficit rose again, however, and in 2002 the deficit was as high as 8.7 per cent of GDP. The large deficits of recent years have been mainly caused by the pension reform: excluding spending on pensions, Bolivia's fiscal balance would have been either balanced or positive between 1997 and 2000 (Grandi and Jemio, 2001:65). Clearly, therefore, the system introduced has overstrained Bolivia's public finances (see also Section 3.8).

Ecuador. With a few exceptions Ecuador's fiscal deficits have been at rather manageable levels and the balance was even positive several times. The deficit of 9.0 per cent in 1987 was caused by a combination of external and internal factors: in 1986 the oil price fell from US$25 to 12 per barrel, resulting in a loss of export revenues equalling 8 per cent of GDP (De Janvry et al., 1991:48); a severe earthquake in March 1987 led to costs of around US$926 million caused by export losses and damage repairs (Corkill and Cubitt, 1988:94); as regards internal factors, Febres Cordero had undertaken a U-turn in his approach to fiscal policy towards the end of his term as he raised the level of wages for government officials, initiated comprehensive public works programmes and increased electricity subsidies (Grindle, 1993). In the late 1990s the fiscal deficit reached unusually high – for Ecuador – levels of 5.1 per cent of GDP in 1998 and 4.6 in 1999. High levels of public sector spending contributed to this situation – damages caused by El Niño in 1998 required around US$300 million in infrastructure investments (Carriére, 2001:144) and the state's bail out of banks costing around US$1 billion in 1998-99 (Lucas, 2000:9). In 2000 the newly installed President Noboa implemented a comprehensive economic reform package called *Ley para la Transformación Económica* (Economic Transformation Law, *Ley* 2000-4, 13.3.2000) which included a strict framework for fiscal policy: a limit of 2.5 per cent of GDP was put on deficits in the non-financial public sector accounts. In 2005, when Palacio took power after the overthrow of Gutiérrez, this law was abolished.

3.3 Trade Liberalisation

Bolivia. Until 1985 Bolivia represented no exception in the region as it was a highly protected country: import tariffs were high and diversified, quantitative import restrictions on many products were in place to protect the domestic industry. In August 1985 almost all these import restrictions were removed and products were allowed to enter the country freely. Imports were charged with a 10 per cent tariff plus a further 10 per cent of the previous tariff rate of this product. This system turned out to be too complicated, however, and by July 1986 the government had changed the tariff policy and imposed a uniform single tariff of 20 per cent on all imports. In 1988 tariffs applying to the imports of capital goods were reduced to an average of 10 per cent and in the same year tariffs on non-capital goods were cut to 17 per cent. In subsequent years tariffs were gradually reduced even further and in August 1990 were at a level of 5 per cent on capital goods and 10 per cent on other imports. By 1991 94.6 per cent of all tariffs were in the range of 5-10 per cent and 5.4 per cent were in the range of 0-5 per cent (Van Dijck, 1998:38). With this level of tariffs Bolivia had become one of the most open economies of the region.[51] Apart from these domestic policy initiatives of trade liberalisation, Bolivia further undertook to open its economy within the framework of the Andean Pact.[52] For most of the 1980s there had been a trade surplus due to the contraction of imports mainly caused by the lack of foreign credits in the aftermath of the debt crisis. With increased tariff liberalisation, however, Bolivia started to import more and more products. Thus, despite a growth in export numbers, the combination of higher spending on imports and declining terms of trade led to sharp trade deficits throughout the 1990s. During the 1990s Bolivia had an average trade deficit of US$409 million per year; in 2000 it was US$583.6 million (see Figure 3.11).

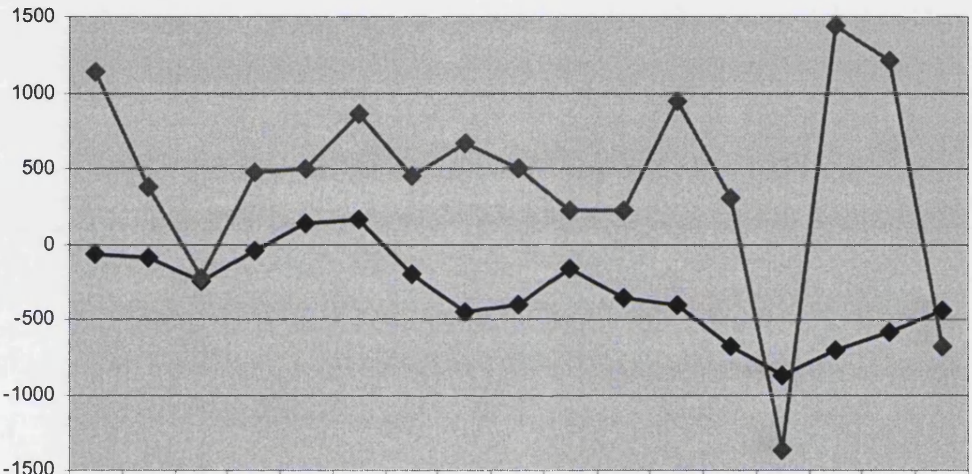
Ecuador. While Bolivia changed from a highly protected trade regime to an open economy within a very short time period, trade liberalisation was introduced much more gradually in Ecuador. Reforms started from 1984 onwards as President Febres Cordero undertook some measures to dismantle the complex system featuring a wide range of variable tariffs and a generally relatively high level of tariffs. Under his administration import quotas on around 600 products were abolished and a number of tariffs were reduced. Yet at the end of Febres Cordero's presidency in 1988, tariffs on manufactured products, for example, could still be as high as 335 per cent, and the average level of import tariffs was 36 per cent (Lynch, 1994b:89). The succeeding government of Borja (1988-92) undertook more substantial trade liberalisation measures: quantitative import restrictions – which in 1990 still applied to about 25 per cent of import products – were

[51] According to Rajapatirana's (1997:183) evaluation of the degree of openness of the economy, Bolivia, by 1992, was the most open economy within South America.

[52] The Andean Group, founded in 1969, consists of Bolivia, Colombia, Peru, Ecuador and Venezuela (Chile withdrew in 1976). It aims to promote increased regional economic integration and to support industrial and technological development. In 1994 a Common External Tariff (CET) was introduced.

reduced by more than half in 1991 (De Janvry et al., 1994:30). Levels of import tariffs were also reduced significantly; now ranging between 2 and 80 per cent. During the government of Durán Ballén free trade agreements were signed with Bolivia and Colombia in September 1992, with Venezuela in January 1993 and in 1994 a common external tariff (CET) was introduced for all members of the Andean Community. While intra-regional trade was completely liberalised by this agreement, the CET was set at a level of 5 to 20 per cent for external products, with the exception of cars, which were charged with a 35 per cent tariff. Ecuador was granted an exception and kept a transitory maximum tariff of 10 per cent above the Andean Pact's CET.

Figure 3.11: Trade Balance (US$m), Bolivia + Ecuador



	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01
Bolivia	-62.5	-86.5	-248	-37.3	135	158	-193	-453	-402	-167	-359	-404	-684	-879	-704	-584	-440
Ecuador	1,138	376	-229	480	499	859	452	671	503	221	228	941	310	-1,37	1,433	1,205	-684

Source: Own elaboration. Data for Bolivia from BCB, 1993, No.280:90; 1997, No. 296:100; 2001, No. 312:118; for Ecuador from BCE (2002).

While the country thus appears to have been on a gradual path towards opening the economy throughout the 1990s, there have been setbacks in the process. In 1998, for example, the government of Alarcón introduced a 4 per cent surcharge on imports, which was increased to 10 per cent in the following year. They were eliminated again in March 2001. In addition, there are still a number of areas of Ecuador's trade system that have not yet been liberalised. For example, around 1,300 products need to be authorised prior to import and some restrictions on importing cars, clothing and tyres are still in place (EIU, Ecuador, 2001:41). In 2004 Ecuador (together with Peru and Colombia) entered negotiations with the USA concerning a new free-trade agreement. Ever since the country gained revenues from oil exports in 1972, Ecuador used to have positive trade balances. It was in 1987 when a first trade deficit was recorded: the trade balance stood at US$–229 million mainly caused due to the lack of oil revenues in the aftermath of the earthquake and the low level of world prices for oil. From 1988 Ecuador accounted trade surpluses again though numbers varied enormously. During the economic crisis of 1998-99 the trade balance experienced a drastic turnaround: in 1999 imports had contracted by 50 per cent due to the decline in aggregate demand, the extreme depreciation of the sucre (ECS), as well as the lack of credits. At the same time oil revenues had increased significantly and, as a result of these two trends, there was a trade surplus of US$1.4 billion in 1999 (see Table 3.11).

Table 3.12: Trade Liberalisation Policies: Bolivia + Ecuador

<table>
<tr><th></th><th>1985</th><th>1990</th><th>1995</th><th>2000</th><th>2005</th></tr>
<tr><td>Bolivia</td><td colspan="5">• almost all import restrictions removed;
- 10% tariff on imports + 10% of previous tariff

• single tariff of 20% on imports;
⇒ tariffs further reduced – by 1990: 5% on capital goods, 10% on other imports</td></tr>
<tr><td>Ecuador</td><td colspan="5">⇒ 1984-88: reduction of tariffs; cancellation of import quotas on 600 products
• average of import tariffs 36%; max. rate 335%
• quantitative import restrictions halved;
- tariff range reduced to 2-80%
• 4% surcharge on imports;
⇒ increased to 10%;
⇒ abolished</td></tr>
</table>

Source: Own elaboration.

3.4 Financial Liberalisation

Bolivia. The economic reform package of the NEP contained several measures aimed at the financial sector. One of them allowed interest rates for transactions of Bolivian pesos and foreign currency to be set freely by the financial markets. In consequence, interest rates fell substantially after having been at very high levels during the period of hyperinflation. While deposits denominated in US-dollars had been prohibited since 1982, this policy was reversed in 1985 and banks were again allowed to accept foreign currency deposits. The effect was that by 1989 84 per cent of all deposits were dollar-denominated (Morales, 1991:24).[53] As a result of the new policy on dollar-denominated deposits Central Bank reserves increased significantly as flight capital was repatriated:

[53] In addition to allowing dollar-denominated deposits, enquiries related to the origins of deposits were prohibited. This seems to have been effective in keeping great amounts of narco-dollars in the country.

deposits increased from US$24 million in December 1985 to US$490 million by the end of 1989 (Morales, 1991:36). This, in turn, allowed the Bolivian government to finance the stabilisation programme and to mitigate the effects of shortfalls in export earnings until funds from multilateral creditors were again available as from June 1986 (Cariaga, 1990:48). In 1993 a new round of reforms of the financial system began, which was to improve banking supervision and gradually lower real interest rates. Yet these reforms did not prevent a banking crisis from occurring soon afterwards. In the aftermath of the 1994 Mexican peso crisis Bolivia had to cope with a radical drop in deposits and several banks faced extremely difficult situations. Between 1994 and 1996 6 out of 17 banks were in precarious conditions, two of them had to be liquidated (see Morales, 2001).

Partly in response to the banking crisis, further financial sector reforms were introduced in 1998. A new body was set up to supervise and regulate the whole financial system.[54] In addition, new regulations concerning reserve holdings were implemented: banks were now required to hold 2 per cent of eligible deposits in cash and an additional 10 per cent in a special fund.[55] This policy aimed at reducing the costs of financial intermediation and enhancing stability in the banking sector: when needed banks could apply to the liquidity fund for short-term loans, thus enabling them to overcome temporary cash flow difficulties. Taking a further step towards financial sector liberalisation the government of Banzer fully opened the country to foreign bank operations in 1998. These policy reforms undertaken in the 1990s contributed to reducing the level of interest rates: while for boliviano-denominated deposits they fell from 21.7 per cent in 1995 to 12.3 in 1999, interest rates for dollar-deposits declined from 11.3 to 8.8 per cent in the same period (EIU, Bolivia, 2001:44). The comparatively high interest rates prevailing in Bolivia, combined with the decision to allow dollar-denominated deposits in 1985, led to a large increase in deposits. While around US$700 million were deposited at Bolivian banks at the end of 1990, this figure had risen to US$3.8 billion in 2000 (EIU, Bolivia, 2000:31; 2001:31). Despite all economic reforms undertaken, however, the lack of confidence in the local currency has persisted: 97.9 per cent of all deposits were dollar-denominated at the end of 1999 (EIU, Bolivia, 2001:31).

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[54] Confip (*Comité de Normas Financieras Prudenciales*) consists of representatives of the Ministry of Finance, the Central Bank and the sectoral superintendencies.

[55] The fund is named: *Requerimiento de Activos Líquidos* (RAL). The local part of this fund is administered by the Central Bank, while a foreign fund manager administers the foreign paper, which makes up around 90 per cent of the RAL. For more details see EIU, Bolivia, 2000.

Ecuador. In the 1980s Ecuador started a gradual liberalisation of its financial sector, with the first reforms implemented by Febres Cordero in August 1986 allowing banks to freely set interest rates. In consequence savings and investment levels increased. This process was offset, however, by external shocks – a fall in oil prices in 1986 and the earthquake of 1987. In 1988 real interest rates on deposits turned negative and savings levels diminished. This gap narrowed throughout the following years until in 1992 most real interest rates were close to being positive (EIU, Ecuador, 1992-93:28,30). A significant reform of the financial sector was the *Financial Institutions Law* of 1994: it allowed dollar-denominated accounts, lowered the reserve requirements, abolished directed-credit schemes and permitted offshore accounts (Beckerman, 2002:45). While the legislation brought increased financial liberalisation, no reforms were carried out to strengthen the area of bank supervision, the deficiencies of which became especially evident from 1995 onwards as the level of bad debts that banks had accumulated was revealed and as a high number of illegal deposit-taking cases was discovered.

In the aftermath of El Niño, which triggered economic stagnation and production losses, the amount of bad debts rose dramatically in 1998. As the financial sector was increasingly deprived of liquid assets and there was little access to foreign credit, more and more Ecuadorian banks were in a precarious position. Despite the intervention of the state granting emergency credits to 29 banks in December 1995 and thereafter (see EIU, Ecuador, 1997-98), a number of banks collapsed in the following years and by 2001 only 26 banks out of previously 42 remained (EIU, Ecuador, 2001:40). According to estimates by Salgado this bailing-out process incurred costs of around one-third of 1998's GDP (cited in CELA, 2000:14). Ecuador's banking crisis seems a prominent example of how liberalising the financial sector without having sound frameworks of supervision and regulation in place can be hugely damaging for a country's economy. In 2000 an attempt to stabilise the shaken financial sector was made by introducing the *Ley para la Transformación Económica*. It contained new regulations for the financial sector, including a limit on interest rates and the introduction of the Basle standards of capital adequacy.[56] The implementation of these has been delayed, however, due to a lack of resources.

[56] The *Basle Accord* of 1988 provides a basis for international co-ordination among banking authorities, contains guidelines on effective supervisory systems and determines standards of international convergence of capital ratios. See Johnson, 2000. The Basle Committee has revised the previous accord and Basle II was finalised in 2004 and is planned to be implemented by 2008.

Table 3.13: Financial Liberalisation Policies: Bolivia + Ecuador

	1985	1990	1995	2000	2005
Bolivia	• Interest rates freed; - dollar-denominated deposits allowed		⇒ 1994-97 – Banking crisis	• Bank Supervision Reform: removal of remaining obstacles on foreign bank operations	
Ecuador	• Interest rates freed		• Dollar-denominated deposits allowed; reserve requirements lowered	⇒ Banking crisis • Limit on interest rates	

Source: Own elaboration.

3.5 Exchange Rate Policy

Prior to the introduction of market-oriented reforms, many Latin American countries had fixed and multiple exchange rates in place, which were often considered as contributing to generating capital flight and deterring foreign direct investment (McCoy, 2000).

Bolivia. While the US dollar was worth 20 pesos throughout most of the 1970s, the Bolivian currency was devalued for the first time to Ps24.51:US$1 in 1979 (EIU, Bolivia, 1994-95:8). In subsequent years the exchange rate was modified repeatedly and under the Siles Zuazo government the currency was devalued seven times between November 1982 and May 1985 (Dunkerley, 1992). Despite these adjustments the gap between the official and the parallel rate was still enormous: in May 1985, for example, the official rate was Ps67,000:US$1 following a devaluation, while the parallel rate stood at Ps250,000:US$1 (Dunkerley, 1992:191). When Paz Estenssoro came to power in 1985 he announced the creation of *"a single, real rate of exchange"* (cited in Lynch, 1994a:104). This promise was translated into action by a drastic devaluation of the currency in August 1985, which substantially narrowed the disparity between official and parallel rate. From now on the Bolivian currency was allowed to float against the dollar and the exchange rate was determined by the Central Bank through daily currency auctions: the Central Bank decided on the quantity of dollars to be auctioned, set a floor price and then sold them to the highest bidders. The official exchange rate is set by the average of all bids placed for the currency. This system resulted in setting a much more realistic exchange rate and by 1987 the official and the parallel exchange rate differed by 1 per cent only, while there had been a gap of 1,367 per cent between them at the time Paz Estenssoro became President (Lynch, 1994a:108). A new currency, the boliviano (BOB) was introduced to replace the peso on 1 January, 1987. Exchange rate policy was an important tool as the radical devaluation in 1985 abruptly ended hyperinflation and as the subsequent relative stability of the currency has since then contributed significantly to greater economic stability.

Ecuador. In the decade between 1971 and 1981 the exchange rate remained unchanged at 25 sucre to the dollar, while during the same time period consumer prices increased fourfold. The resulting permanently overvalued exchange rate created an anti-export bias as imports were relatively cheap while exports were uncompetitive in foreign markets. In 1982, during the government of Hurtado, the currency was devalued for the first time in a decade and from 1983 onwards a system of regular "mini-devaluations" was established. Two years after coming to power, in August 1986, Febres Cordero allowed the currency to float freely against other currencies, which had the effect of a rise in the sucre from 110 to 150 to the dollar within a couple of days (Lynch, 1994b:91). Febres Cordero soon abandoned this market-determined exchange rate, however. In March 1988 a "controlled free rate" for private sector goods trade was introduced, only to be abolished again five months later by his successor Borja who returned to an exchange rate system consisting of an official, an intervention and a free market rate.[57] Simultaneously, the exchange controls eliminated two years earlier were reintroduced in August 1988; lifted again on exports in 1989 and on imports in 1992.[58]

During the 1990s the exchange rate system continued to be modified repeatedly and *"Ecuador attempted almost every possible permutation for its exchange-rate system"* (EIU, Ecuador, 2000:44). At the end of 1994 the government of Durán Ballén introduced a crawling-peg exchange-rate system with an exchange rate band of ECS50. This enabled the *Banco Central del Ecuador* (Central Bank, BCE) to devalue the currency within certain limits. The crawling-peg system remained in place until 1999

[57] The intervention rate applied to all trade transactions, foreign debt service and foreign investment profit remittances, while the official rate applied to Central Bank accounting.

[58] Exporters had to sell foreign currency earnings to the Central Bank at 5% below the intervention rate to change into sucre, while importers were sold foreign currency at 5% above the intervention rate, which resulted in a 10% transaction fee charged by the Central Bank. The Borja administration, in an attempt to promote export competitiveness, abolished the 5% payment of exporters in 1989 and exchange controls on imports were lifted in September 1992 under the presidency of Durán Ballén.

when Ecuador allowed the currency to fluctuate depending on market conditions. Due to the combination of a financial crisis, a huge fiscal deficit and a loss of confidence in the sucre, the currency depreciated enormously: while at the end of 1998 the exchange rate stood at ECS6,825 to the dollar, it declined to a rate of ECS20,243 to the dollar at year-end 1999 (EIU, Ecuador, 2001:51). Facing a continued fall of the currency the government of Mahuad opted to take a radical measure: in January 2000 the Ecuadorian economy was dollarised. The exchange rate was set at ECS25,000 per dollar and the national currency was replaced by dollars from April onwards. Exchange rate policies have terminated with the dollarisation of the economy.

Table 3.14: Exchange Rate Policies: Bolivia + Ecuador

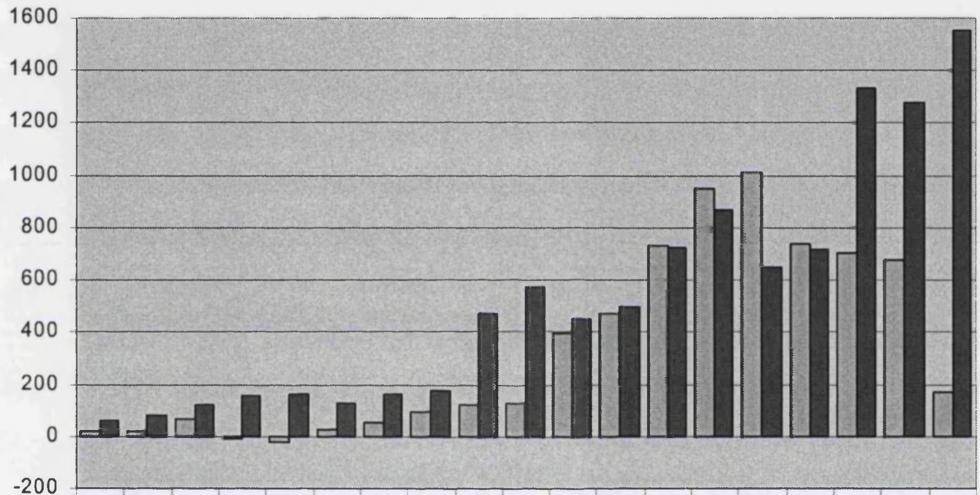
	1985	1990	1995	2000	2005
Bolivia	• floating exchange rate				
		⇒ official and parallel rate almost identical			
Ecuador	• floating exchange rate				
		• return to fixed exchange rate;			
			• crawling-peg exchange rate system		
				• floating exchange rate	
				• dollarisation	

Source: Own elaboration.

3.6 FOREIGN DIRECT INVESTMENT

Bolivia. Despite the comprehensive economic reforms undertaken during the presidency of Paz Estenssoro, no policies concerning foreign direct investment (FDI) were introduced between 1985 and 1989. Given the changed political and economic environment, the stabilised currency and the tax reforms of this time period, however, incentives for attracting foreign investment had been created. Yet with an amount of 27 million in 1990 foreign investment was still at a rather irrelevant level (see Figure 3.15). To some extent the slow uptake is based on factors which were impossible to change in the short run: the underdevelopment of the infrastructure and the very limited size of Bolivia's domestic market contributed to providing little incentives for foreign investors. Under the government of Paz Zamora (1989-93) new legislation introduced in January 1990 allowed foreign investment in the mining and hydrocarbons sectors and a number of legal guarantees – such as free import of goods and services, free exchange convertibility, and equal status to domestic firms before the law – were accorded to foreign investors. The new law succeeded in its aim of attracting more FDI: in the mining sector, for example, the number of foreign companies rose from 4 in 1991, to over 50 in 1996 (EIU, Bolivia, 1998-99:23). Between 1990 and 1994 investment levels increased from US$27.2 to 130.2 million (see Figure 3.15). The capitalisation process (see next section) made FDI surge from 1995 onwards yet with the end of this process, FDI levels started to decline again. In a further move, the so-called *Ley Corazón* was passed in 1999: the previously confined area of a 50 kilometre radius from Bolivia's borders was opened for foreign companies to own property in order to encourage the construction of power plants exporting electricity.

Figure 3.15: Foreign Direct Investment, net inflows (current US$m), Bolivia + Ecuador



	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03
Bolivia	19	20	68	-10	-24	27	52	93	124	130	393	474	731	949	1,01	736	706	677	167
Ecuador	62	81	123	155	160	126	160	178	474	576	453	500	724	870	648	720	1,32	1,27	1,55

Source: Own elaboration. Data from World Development Indicators (April 2005).

Ecuador. With the establishment of the petroleum sector in the early 1970s, Ecuador became attractive to foreign investment: in 1971 there were 36 foreign companies active in oil exploration; between 1972 and 1974 FDI reached 5 per cent of GDP (EIU, Ecuador, 1992-93:20; Larrea, 1998:187). From the mid-1970s, however, this process of investment liberalisation was reversed and the petroleum sector was gradually nationalised leading to the departure of more and more foreign companies. By 1981 only five of the previously 36 companies were still operating in Ecuador (EIU, Ecuador, 1992-93:20). During the 1980s few policy efforts were made to attract foreign direct investment; first steps were undertaken by the government of Borja (1988-92) who, however, took a rather mixed approach: while foreign investment especially in oil exploration was desired, negotiations were often led in inconsistent ways. In 1991, for example, a large-scale oil exploration programme proposed by the US oil company *Conoco* failed due to administrative delays (EIU, Ecuador, 1992-93:22). This indecisive approach resulted in rather low levels of FDI, which amounted to an average of US$150 million annually between 1988 and 1991 (see Figure 3.15).

More wide-ranging changes to investment legislation were carried out under Durán Ballén (1992-96): in January 1993 investment in previously banned areas was allowed and limits on profit remittances (except for the mining sector) were abolished. As a result FDI increased significantly: while US$178 million had been invested in 1992, in the year the new legislation was introduced it rose to US$474 million (Figure 3.15). Despite these substantial measures, some sectors still remained protected (i.e. the mass media, defence, fishing, border areas and domestic air transport) until new legislation passed in 1997 removed these remaining obstacles to foreign investment in all but the areas of defence and telecommunications (*Ley* 46, 19.12.1997; CORPEI, 2004). At the same time it was decided to give foreign investment equal treatment to domestic investment. A recent project, which attracted great amounts of foreign investment, was the construction of a new oil pipeline (*Oleoducto de Crudos Pesados,* OCP). The contract for this project was signed in February 2001 and the responsibility for building and maintaining the OCP was given to a consortium of five foreign companies. It is the petroleum sector which has predominantly attracted foreign investment; other areas of Ecuador's economy have often failed to attract FDI. According to an EIU report (2000:42):

"Political and economic instability and a lack of progress on economic reform have deterred FDI inflows to most sectors of the economy, other than to the extractive and energy industries."

Table 3.16: Foreign Direct Investment: Bolivia + Ecuador

	1985	1990	1995	2000	2005
Bolivia		• foreign investment allowed in mining and hydrocarbons sector; - equal treatment of domestic and foreign investment; - bilateral agreement to promote US investment		• border areas opened to FDI	
Ecuador		• liberalisation of previously restricted areas; - limits on profit remittances abolished	• most remaining protected areas liberalised; - equal treatment of domestic + foreign investment		

Source: Own elaboration.

3.7 PRIVATISATION[59]

Bolivia. It may appear contradictory that the same person who had led the Bolivian Revolution of 1952 and introduced a state-led development strategy during his first term as President (1952-56), implemented a radical neoliberal economic programme when returning to power in 1985. However, there is some consistency in Paz Estenssoro's economic policy-making, as a main objective of the NEP was to restore the authority of the state and to aim at a dominant role of the state in planning and investing in strategic sectors such as mining. Consequently, it seems hardly surprising that no attempts to transfer enterprises from public to private ownership were being made under his government. Some national enterprises, however, were transferred to regional development corporations and municipalities – a process interpreted by Morales (1994:141) as an *"intermediate step toward privatisation"*. Under the subsequent administration of President Paz Zamora (1989-93), privatisation featured rather low on the policy agenda as well. In a *"lukewarm attempt to privatise"* (Cominetti and Hofman, 1998:73) Paz Zamora implemented a privatisation law in 1991 which was to facilitate the transfer of some small enterprises to the private sector; the large and strategic sectors would remain in the hands of the state. Only very few state-owned enterprises were privatised by 1994, however. Under the presidency of Sánchez de Lozada (1993-97) was a clear strategy about restructuring the state-owned industry implemented. Instead of opting for *"straightforward privatisation"* (Van Dijck, 1998:36), Bolivia decided to "capitalise" its public enterprises and in February 1994 the *Capitalisation Law* was passed by the Bolivian Congress. Under this scheme private investors were allowed to bid for a 50 per cent stake in a state-owned company and subsequently take over its management. Instead of paying for their share of the enterprise, investors made a pledge to invest a certain amount in the company within a specified time period. The state, for its part, allocated the remaining half of the shares to the public to set up a pension system. All Bolivians over the age of 21 (by December 1995) were made shareholders of the capitalised enterprises, resources were deposited into a pension fund, and pension payments were to be paid out to people reaching the age of 65 (*Ley* 1544, 21.3.1994). The Bolivian strategy provided an alternative to using privatisation for simply reducing public sector deficits and instead created a long-term scheme to finance social spending.[60] Alongside the capitalisation process, however,

[59] Privatisation is here used in its more narrow meaning and refers to a transfer of public enterprises to the private sector.

[60] For more information on the capitalisation scheme, see: Cominetti and Hofman, 1998; Salinas et. al., 2002.

some state companies also underwent straightforward privatisation. Between 1988 and 1995 57 companies were privatised providing a revenue of US$810 million to the state (Bouton and Sumlinski, 1997); in the course of the capitalisation scheme US$1.6 billion were raised by year-end 1998 (Grebe Lopéz, 2001:164).

To summarise, in contrast to other *Washington Consensus* policies privatisation has been one in which Bolivia proceeded rather reluctantly. It was only in 1994 that a privatisation strategy was developed. Even then Bolivia did not implement privatisation in the traditional form but created its own scheme named capitalisation. Bolivia's – as well as Ecuador's – reluctance to implement conventional privatisation policies comes as little surprise when considering the high degree of opposition to privatisation: a recent survey by *Latinobarómetro* showed that around 70 per cent of both Bolivia's and Ecuador's population disapprove of privatisation processes. [61] Bolivia's anti-privatisation protests in Cochabamba in 2000, resulting in the departure of the US company which had just acquired the city's concession for water supply, as well as the current demand to nationalise the hydrocarbons sector, provide prominent examples of the extent of opposition in Bolivia.[62]

Ecuador. When considering privatisation policies, one has to take into account that Ecuador *"never had such an extensive network of state enterprises as to make this an urgent issue"* (Williamson, 1990b:56). Under the presidency of Febres Cordero some first steps were undertaken and new legislation allowed the privatisation of state-owned enterprises (SOEs). The first transfers from public to private sector were carried out in 1987 and 1988 with the sale of the banks *Financiera Manabí* and *Financiera Guayaquil* (Zank, 1990). While the Febres Cordero administration had thus paved some ground, little progress was made under the subsequent government of Borja. Notably, Ecuador even pursued policies to nationalise some sectors and thus acted in stark contrast to the prevailing logic of private sector superiority as advocated under the *Washington Consensus*. In September 1988, Borja announced that the state would take control of all oil production sections in which foreign companies had so far been involved. Around

[61] Latinobarómetro, 2001, cited in: Research Department Inter-American Development Bank (2002). "The Privatization Boom in Latin America", in *Latin American Economic Policies*, Vol. 18:2.

[62] In 1999 the license for water supply of Cochabamba was sold to the US company Bechtel. Subsequently, water rates increased substantially. The local population reacted with huge demonstrations starting in January 2000, at times attracting as many as 100,000 people. In the following battles between police and protesters more than 175 protesters were injured, some of them killed. Finally, the government ceded to the pressure and cancelled the contract. Bechtel claimed compensation of around US$40 million. For more information see: *Fundación Milenio*, 2000a:33ff; Crabtree, 2005:16-32.

one year later, the trans-Andean pipeline, previously controlled by Texaco, was taken over by the state oil company (*Corporación Estatal Petrolera Ecuatoriana;* later *Petróleos de Ecuador*, Petroecuador). This process of expanding the public ownership continued during subsequent years and by 1992 Petroecuador had taken full control of Texaco's oil production facilities, which previously accounted for 87 per cent of the sector (EIU, Ecuador, 1992-93; 1993-94). Durán Ballén (1992-96) changed Ecuador's course again and Congress passed a *Modernisation Law* in 1993, which provided a legal framework for privatising state-owned enterprises. Yet despite the aim of privatising 80 per cent of the state companies during his mandate, only a small number of companies – such as the national airline (*Compañia Ecuatoriana de Aviación*) as well as some hotels and banks – were actually transferred to the private sector. Reasons for the government's failure included the widespread opposition to privatisation policies:

"Opposition parties in Congress managed to hold up any large-scale privatisation by blocking the necessary legislation, while public opinion polls revealed that 80% of Ecuadorians were against the program." (Roos and Renthergem, 1997:48)

Table 3.17: Privatisation: Bolivia + Ecuador

	1985 1990 1995 2000 2005
Bolivia	• Privatisation Law; outlines privatisation of small enterprises, large + strategic ones to remain state-owned; • Capitalisation Law
Ecuador	• Legislation amended to allow privatisation of SOEs • Nationalisation policies in oil production sector • Modernisation Law: Durán Ballén aims to privatise 80% of SOEs but achieves little • Legislation to accelerate privatisation largely fails

Source: Own elaboration.

Between 1988 and 1995 only eleven state enterprises were privatised resulting in total revenue of only US$169 million (Bouton and Sumlinski, 1997). During this time, Ecuador *"lagged behind most other Latin American countries in the number of enterprises privatized, revenues raised from privatization, and foreign investment inflows from privatization"* (Nazmi, 2001:728-9). In 1998 crucial constitutional reforms were made and governments were now allowed to sell partial stakes in state-owned enterprises in strategic sectors such as electricity, telecommunications, water, and roads. In 2000 an attempt was made to introduce legislation that would facilitate the privatisation of public enterprises but largely failed (see Chapter 7.2). To summarise, despite implementing some legal changes quite early, Ecuador has proceeded rather slowly to privatise state-owned enterprises and not always consistently. While the necessary legislation is now in place, many enterprises are still publicly owned. As in the case of Bolivia, however, privatisation processes are not purely a matter of political will but often state companies simply cannot be sold due to the absence of buyers. In 1997, for example, Ecuador tried to sell a 35 per cent stake in the telecommunications enterprises *Andinatel* and *Pacifictel*, but failed to do so given the lack of bidders (EIU, Ecuador, 1997-98).

3.8 Social Security

Bolivia. From 1956 until 1996 Bolivia had a pay-as-you-go pension system in place, which over the years faced more and more problems due to administrative difficulties but also because the numbers of beneficiaries were rising while those of contributors were falling. In consequence, the basic pension system practically collapsed at the end of the 1980s. During the government of Sánchez de Lozada (1993-97) a new pension system was introduced forming part of the capitalisation strategy. The *Ley de Pensiones*, passed in November 1996, established a new pension system that was to be funded by the revenues of the capitalisation of public companies. In this system private pension funds would manage the dividends gained from the shares of the capitalised enterprises. It entailed an annual payment of a *Bono Solidario* (*Bonosol*) to all Bolivian residents over 65 years of age; when it was first paid in 1997 the amount was US$248 per person. The total cost of this scheme reached US$95 million in this first year, about half of which had to be financed by external borrowing given that the revenues from the sale of enterprises were too low to cover the costs (Cominetti and Hofman, 1998:73). Already in 1998, now under the presidency of Banzer, the payment of the *Bonosol* had to be postponed given the financial strain the pension payment represented. Banzer then set out to reform the whole system and replaced the *Bonosol* by giving people the choice to either receive "popular shares" or to receive the *Bolivida*, an annual payment for people over 50. The *Bolivida*, worth US$60, was first paid in December 2000 (EIU, Bolivia, 2001:23). When Sánchez de Lozada returned to power in 2003 he reinstalled the *Bonosol* and increased the value of the annuity payment to BOB1,800 (ca. US$234) for the period 2003-07. According to the Economist Intelligence Unit the current level of payments is not sustainable (EIU, August 2004:22). The pension reform has led to a large increase of fiscal deficits (see Section 3.2).

Apart from the pension scheme, social funds have become an integral part of Bolivia's social security system. In 1986 the first of those funds was set up: the *Fondo Social de Emergencias* (FSE) was funded by foreign donors and created around 100,000 temporary jobs within community construction projects (Conaghan, 1994b:256). Countries throughout the region soon took up this model and also established social funds. Following the FSE a variety of other social funds was set up in Bolivia during the last two decades, all aimed at improving the living conditions of the poorest sectors of society.

Ecuador. While Bolivia was one of the nine Latin American countries which have carried out structural reforms of their pension systems during the last two decades (Mesa-Lago, 2005)[63], Ecuador has so far not restructured its system. Ecuador uses a pay-as-you-go social security system, which would need to be radically reformed to make it sustainable (Beckerman, 2002:43). The central government provides contributions to its employees and also subsidises the Ecuadorian Social Security Institute (*Instituto Ecuatoriano de Seguro Social*, IESS), covering 40 per cent of the institute's pension payments as well as other costs. The IESS remains solely in charge of the pension scheme; the private sector has not been involved in the system. In 1998 a new element was added to the social safety net as President Mahuad introduced the so-called *Bono Solidario*. This scheme provides a small monthly payment to pensioners and mothers of families whose income is below a certain limit.[64] While the *Bono Solidario* was originally created with the purpose to soften the effects on the poor caused by a reduction in subsidies Mahuad had implemented, it has turned into the central element of the country's social security system. In 1999 around 45 per cent of households received the *Bono Solidario*; the government spent 1.2 per cent of Ecuador's GDP on the programme in 1999, and around 0.8 per cent of GDP in 2000 and 2001 (Parandekar et al., 2002:152). Research has shown that the scheme does not always reach its target group of poor families (Beckerman, 2002:40). Several small-scale social security provisions exist, such as a fund that finances infrastructure projects in emergency situations, and others providing assistance in the areas of education, health and nutrition.

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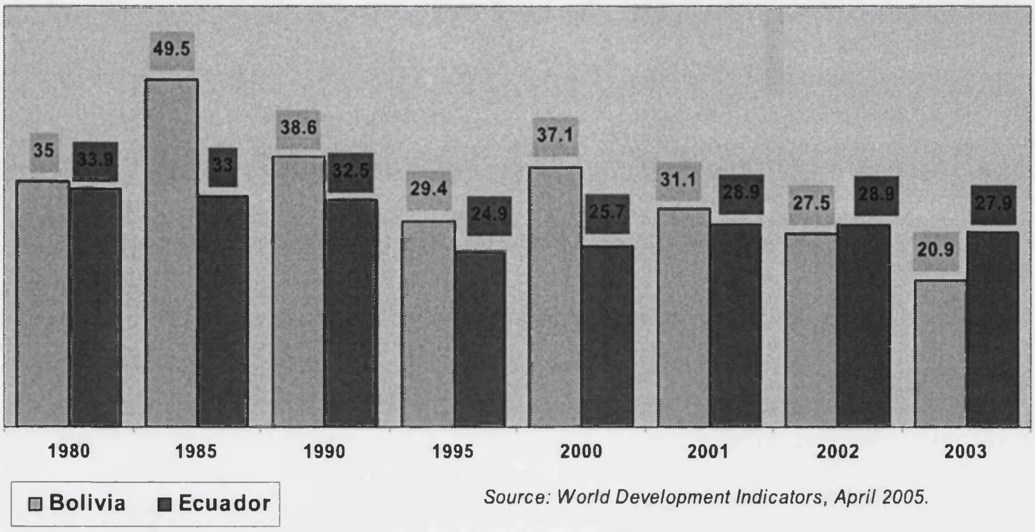
[63] Chile (1981), Peru (1993), Colombia and Argentina (1994), Uruguay (1996), Bolivia and Mexico (1997), El Salvador (1998), Costa Rica (2001), and the Dominican Republic (2003-06) reformed their pension systems (Mesa-Lago, 2005:687ff.).

[64] At first mothers were paid US$15 per month and pensioners about half this amount (Parandekar et. al., 2002:151); to qualify household income had to be below US$150.

3.9 MISCELLANEOUS (FOREIGN DEBT, HYDROCARBONS, COCA, AID)

Foreign Debt.

Figure 3.18: Total Debt Service (% of exports), Bolivia + Ecuador



Source: World Development Indicators, April 2005.

Bolivia. As in the rest of Latin America, Bolivia obtained a large number of foreign credits during the 1970s: its debt rose from US$782 million in 1971 to US$3.5 billion by 1979 (Jameson, 1989:88). In 1980 Bolivia owed half of its debt to private creditors. From the early 1980s onwards the creditor profile started to change, however, as official creditors (mostly multilateral organisations) were the only ones willing to lend. By 1998 the share of Bolivia's debt to private creditors had fallen to 0.8 per cent (Antelo, 2000:30). It was in June 1986 that Bolivia reached a stand-by agreement with the IMF, for the first time in six years, which allowed the country to have its debt rescheduled in the Paris Club and re-opened the doors for new credits provided by the multilateral organisations. In 1998 Bolivia qualified for the HIPC (Heavily Indebted Poor Countries) initiative of the IMF and the World Bank, which allowed it to lower its debt levels. The debt relief granted to Bolivia under the HIPC terms amounted to US$156.8 million in 2002, and reached US$153.4 million in 2003 (*Fundación Milenio*, 2004:17).[65] The degree of indebtedness has gradually fallen during the last twenty years: while the debt service (as percentage of exports) was 45 per cent on average during the 1980s, it was reduced to 32 per cent on average during the 1990s; the rate for 2003 was 20.9 per cent (WDI, 2005).

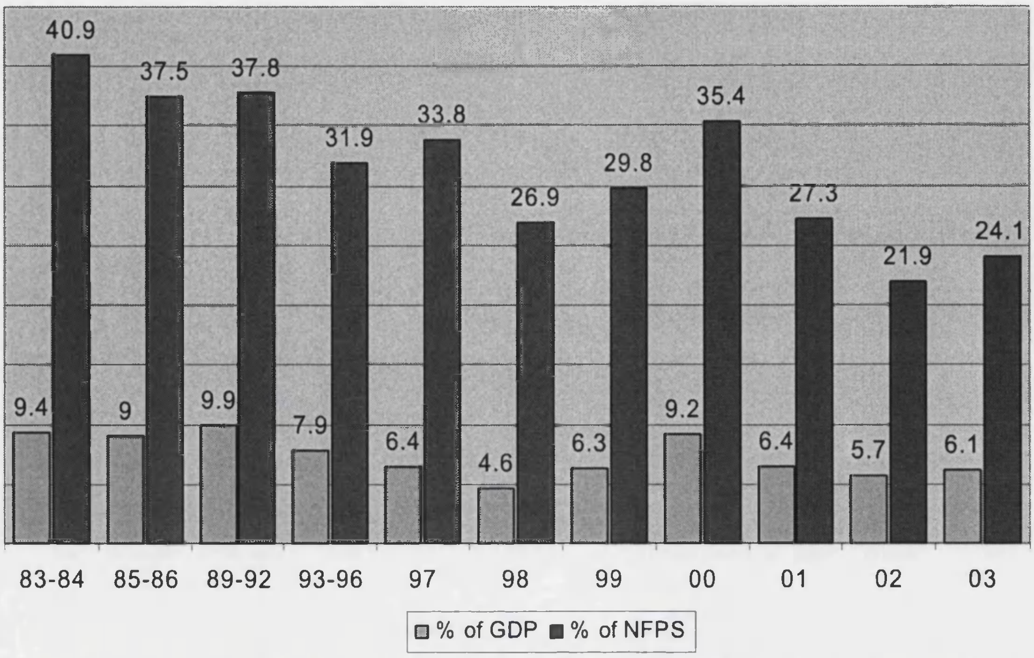
[65] The G-8 summit of July 2005 decided an extension of the HIPC terms for 18 countries, among them Bolivia. The specific terms are as yet unclear, however.

Ecuador. Parallel to Ecuador's petrol boom during the 1970s, the country accumulated a huge amount of debt within a relatively short time period: foreign debt rose from US$242 million in 1970 to US$7.7 billion in 1982 (EIU, Ecuador, 1992-93:37). The total debt grew more slowly from 1982 onwards as the availability of credits decreased. In October 1982 the country re-scheduled its debt for the first time and since then has done so several times. In 1995 Ecuador qualified for the Brady Plan[66], which entailed re-structuring the debt and had the effect of making new credit lines available. With the onset of the economic crisis and currency depreciation in the late 1990s, total debt levels rose again dramatically: from 77 per cent of GDP on average during 1995-98 to 105 per cent in 1999 (EIU, Ecuador, 2000:41; 2001:47). In consequence, Ecuador was unable to fulfil its obligations and in 1999 was the first country to default on its Brady Bonds. In the subsequent negotiations with the private sector creditors, the Ecuadorian government secured a significant write-off. Due to the low rate of US dollar GDP at that time, however, the debt stock only decreased from 105 per cent of GDP in 1999 to 94 per cent in 2000 (EIU, Ecuador, 2001:47). This represents one of the highest debt burdens within South America.

In 2002 Ecuador established an oil fund (called *Fondo de Estabilización, Inversión y Reducción del Endeudamiento Público* – FEIREP), which had the objective to reserve resources for debt payments: 70 per cent of the fund was used to service the debt, 20 was allocated to stabilisation and aid in case of natural disasters and 10 per cent went to education and health. In June 2005, under the recently installed President Palacio, these provisions were abolished and 35 per cent are reserved for debt buy-backs and to foster economic growth, 30 per cent are destined for social spending, 20 per cent for a trust fund protecting the country from potentially falling oil prices, and 15 per cent will go to environmental, technical and road building projects. During the 1980s Ecuador spent on average 41.2 per cent of its export earnings on servicing its debt; this level declined to 27.2 per cent during the 1990s; and stood 27.9 at in 2003 (WDI, 2005). While Ecuador's creditor profile also shifted towards multilateral and bilateral creditors during the post-1982 period, the change has not been as significant as in Bolivia. In 2000 Ecuador owed around 52 per cent of its debt to private creditors, 30 to multilateral organisations and 18 per cent to governments represented in the Paris Club (Lucas, 2000:30).

[66] In 1989 US Secretary of the Treasury, Nicholas F. Brady, announced the "Brady Plan" which allowed Latin American countries to restructure their debt into a variety or "menu" of new claims.

Figure 3.19: Oil Revenues, Ecuador



Source: Own elaboration. Salgado and Santos, 1998:14 (1983-96); EIU, 2001:56 (1996-97); 2005:50 (1999-03).

Hydrocarbons. ***Ecuador – oil.*** Oil reserves were discovered in 1967 and by 1972 a pipeline was built and Ecuador started to export petroleum. Revenues from petroleum exports increased from a share of 3.9 per cent of GDP in 1973 to 8 per cent in 1981 (Mosley, 1991:413). During the 1980s and 1990s oil was the country's main export product; in 2004 petroleum exports accounted for 52 per cent of total export earnings (EIU, Ecuador, 2005:36). Oil revenues provided between 9 and 9.9 per cent of GDP during the 1980s; by 1997 declined to 6.4 per cent and in 2003 stood at 6.1 per cent. Representing the state's most important source of income the petroleum sector generated 40.9 per cent of non-financial public sector income in 1983-84, 31.9 per cent by 1993-96 and 24.1 per cent in 2003 (see Figure 3.19). In 2003 a second oil pipeline resumed operations in Ecuador: the *Oleoducto de Crudos Pesados* (OCP). Proceeds from this pipeline were destined for the above-mentioned oil fund.

Oil is certainly the aspect that distinguishes the economies of Ecuador and Bolivia most. Given the importance of oil revenues in the Ecuadorian economy it could be assumed that this has influenced the pattern of tax policy-making. Can the existence of oil explain why Ecuador has been a slow tax reformer while Bolivia has introduced wide-ranging changes to the tax system? While the importance of oil should not be underestimated it is argued here that the pattern of policy-making cannot be accounted for by the existence or non-existence of oil. As can be seen in Figure 3.19, the role of oil in Ecuador's economy has gradually decreased since the 1980s. While it provided 40.9 percent of the non-financial public sector in 1983-84 it almost halved to 20.9 per cent by 2002. If the argument goes that the memory of the petrol bonanza of the 1970s explains the reluctance of governments and society to reform the tax system and increase collection, then it should have been most difficult to introduce tax reforms during the 1980s. With the decline of oil revenues and the increased consciousness that oil cannot provide for everything, tax policy-making should thus have become gradually easier. Yet this did not happen. On the contrary, the only two cases where significant tax bills were introduced as suggested by the government occurred in 1986 and 1989 (See Chapter 6). In the period since the early 1990s the introduction of tax reforms was extremely difficult for governments and generally they either failed or were significantly modified. This pattern is contrary to what one would expect if oil were the determinative variable in explaining the successful introduction of tax policies. Oil is not enough to explain why tax reforms either succeeded, failed or were modified in Ecuador.

Bolivia – natural gas. Within the hydrocarbons sector oil plays only a limited role in Bolivia's economy as all crude oil produced is consumed within the country. Natural gas, on the other hand, has become an important element and replaced tin as the biggest contributor to export earnings from 1980. In recent years its (potential) importance has further increased as since the mid-1990s large gas reserves have been found. Between 1997 and 2003 the discovery of natural gas resources grew ten times (EIU, Bolivia, 2004:28), which made Bolivia the country with the second-largest reserves in Latin America after Venezuela. Bolivia's hydrocarbons industry was nationalised in 1937 and started to be managed by the state company *Yacimientos Petrolíferos Fiscales Bolivianos* (YPFB). The YPFB held all rights over exploration and exploitation activities (also known as upstream activities) and also controlled the stages of refining and commercialisation (downstream activities). In 1990 the Paz Zamora government introduced a hydrocarbons law that submitted all upstream activities to a 50% royalty payment (*Ley* 1194). In 1994 the tax reform introduced by Law 1606 (see Chapter 4.4 for other elements) also entailed significant changes to the hydrocarbons sector: a special tax on hydrocarbons (*Impuesto Especial a los Hidrocarburos y sus Derivados*, IEHD) was created. It charges the commercialisation of hydrocarbon derivatives in the internal market be they internally produced or imported; the rates applied vary according to product. The new legislation also integrated the sector into the general tax regime, meaning that companies involved in any stage of the hydrocarbons industry would have to pay the corporate income tax (which was created by Law 1606). During the government of Sánchez de Lozada (1993-97) the sector was opened up after a new Hydrocarbons Law was passed in 1996 and the YPFB was gradually privatised. Private companies were given the right to export gas anywhere and at any price they chose. To attract investment in the sector royalties on new finds were set at 18 per cent only, while wells that were already operating bought by private investors were levied 50 per cent; the difference was to offset the significant costs of exploration. By 2000 all major assets of the YPFB were privatised and exploration and production activities were now fully in private hands. In consequence, private and foreign companies increasingly dominated the hydrocarbons sector and following this law total foreign investment in the sector rose drastically: while around US$200m were invested in 1989 (EIU, Bolivia, 1998-99:27), around US$400m were invested on average between 1998 and 2002 in the oil and gas sector (Dupleich et.al., 2003:24). FDI in this area was higher than in any other since 1997. This therefore underlines the importance of the hydrocarbons sector for the Bolivian economy.

Ever since the early 1970s Bolivia has exported natural gas to its neighbour Argentina. As outlined in Chapter 4.3 Bolivia experienced a budget crisis in 1991 as a twenty-year contract with Argentina expired and as export prices were re-negotiated and set at a much lower level. Consequently export earnings declined from US$232m in 1991 to US$90.2m in 1993 and remained below US$100m during the remainder of the 1990s (Dupleich et al., 2003:32). In the mid-1990s Bolivia won Brazil as a new export market. The construction of a gas pipeline to Brazil started in 1996 and exports commenced in 1999. From then on export earnings from natural gas increased again and went from US$35.5m in 1999 to US$265.6m in 2003 (Dupleich et al., 2003:32). While earnings thus rose significantly after exports to Brazil begun, they never reached the levels of income generated during the 1980s.

Yet while production increased since the late 1990s, Bolivia is far from reaching its capacity for production given the large reserves discovered from the mid-1990s onwards. How to deal with the extensive remaining reserves has become subject to a major political controversy during the last years. The second government of Sánchez de Lozada (2002-03) considered a plan to export natural gas to Mexico and the US via a port in Chile. Though this option seems economically more viable than alternatively using a port in Peru, exporting via Chile is highly unpopular in Bolivia for historical reasons: in the War of the Pacific (1879-83) Bolivia lost its access to the sea to Chile. Domestic opposition to the plan was one of the catalysts for Sánchez de Lozada's downfall in October 2003. Following the demands of large sectors of the society, President Mesa (2003-05) convened a national referendum on the state's control over the privatised hydrocarbons sector in July 2004. The referendum resulted in a success for Mesa as the turnout was around 60 per cent and as all five questions asked were answered with the "yes" that Mesa had hoped for. Though the result clearly expressed the population's interest in increasing state control over the hydrocarbons sector, it remained unclear how this should be translated into specific policies. In 2004 a new hydrocarbons law was discussed in Congress, which proposed to introduce a "complementary" hydrocarbons tax. It was passed in May 2005 and established a 32 per cent complementary tax to be paid in addition to the 18 per cent royalty payments and other taxes of the general tax regime (such as the corporate tax) (see also Chapter 5.3). Additional revenues of around US$320 million are expected (*La Razón*, 18.5.2005). In a first reaction, companies of this sector announced that they were to put all planned investment on hold (*La Razón*, 18.5.2005).

As can be seen from these paragraphs the hydrocarbons sector has played a crucial role in Bolivia's economy. Given the significance of export earnings from this sector, any change in export levels or prices has a huge impact on Bolivia's finances. When in 1991 Argentina was behind with some of its payments and the contract was re-negotiated, a significant budget crisis was created in Bolivia, one of the principal reasons why the Paz Zamora government decided to increase the VAT rate in 1992. Particularly in the last couple of years the issue of how to deal with the natural gas reserves has become highly politicised. In 2003 Sánchez de Lozada's proposal to export via Chile was one of the main triggers of the demonstrations that led to his downfall; in 2004, the wave of protests by social movements who demanded the nationalisation of the sector following the introduction of the hydrocarbons tax led to the resignation of Mesa as president.

In short, the hydrocarbons sector is of crucial importance to Bolivia's economy but has also become an aspect of major political contention, which has played a significant role in the social conflicts Bolivia has experienced during the last years.

Coca. Within Latin America Bolivia is the third biggest exporter and producer of coca after Colombia and Peru. Coca cultivation for the cocaine trade increased throughout the 1970s and 1980s and was concentrated in the Yungas (near La Paz), the Chapare in Cochabamba, and the Yapacani in Santa Cruz. These regions did not only provide the required climate but were also traditionally rather poor rural areas, a combination that made coca production an attractive option. By 1987 coca had become the largest export product, accounting for US$ 700 million in 1988 (Laserna, 1993:55). Revenues from this sector have often helped cushion the effects of austerity measures introduced, particularly during the period of the NEP (1985-89). Given that the USA made their assistance as regards aid and trade concessions increasingly dependent on coca eradication, the Bolivian government introduced several eradication schemes throughout the last two decades.

In 1988 an anti-drug law, the famous *Ley 1008*, was introduced, which had been co-written by the US Agency for International Development. The Law established harsh penalties for drug-trafficking activtities and distinguished between legal production (coca production for traditional use), surplus production (which was to be gradually replaced by alternative crops), and illegal production (which was to be eradicated). The law defined narco-trafficking as illegal and prepared the way for eradicating coca production. Two regions, leaving out the Chapare, were declared as legal coca plantations. The bill was never fully implemented, however, as it was highly controversial within Bolivia. Given the resistance of the cocaleros and the lack of a national consensus on the issue, the Bolivian government never enforced all parts of the legislation. Plantations continued to grow and hardly any cocaine traffickers were prosecuted (Hallums, 1997). A pattern developed that when areas were cleared of coca plantations, producers easily changed location and replanted coca elsewhere. While internally not fully endorsing drug eradication policies, Bolivian governments have, however, continued to sign international drug agreements. Complying with international demands on drug enforcement was, as Hallums (1997:827) termed it, *"a political and economic necessity"* for Bolivia. Given the economic situation of Bolivia and its dependence on foreign aid, governments have generally chosen to pass anti-drug measures to please the US and other countries. Yet as pointed out by Painter, Bolivian governments have tried to maintain a balancing act between external pressure and domestic resistance to coca eradication by following *"the politically expedient path of doing the minimum necessary to appease the international community and thereby* *convince foreign governments of the wisdom of giving economic aid, while doing the least possible to disrupt the social peace of the country"* (Painter, 1994:77).

In 1997, however, things started to change as Banzer came to power (see Chapter 5.1). He announced the *"Plan Dignidad"*, which aimed at alternative development, eradication of coca, and drug use prevention. With strong support from the US, the Banzer government undertook a very active and often aggressive eradication campaign. [67] As regards eradication the *"Plan Dignidad"* seems to have been successful: fields were reduced from 48,000 ha in 1995 to 19,000 in 2001 (of which 12,000 are legal).[68] In consequence, revenues from the coca trade were reduced: while they represented 3.9 percent of GDP in 1990 they declined to 0.7 percent by 2003 (EIU, Country Profile 2004:26).[69] The other side of this success was of course that the living standards in the Chapare sharply declined following the forced comprehensive eradication. This in turn led to social unrest and protests against the government. The Bolivian governments' policy of co-operating with the US and eradicating coca plantations has led to a violent conflict in the Chapare. Settlements started growing in the Chapare from the 1970s onwards and significant numbers migrated there after the tin mines were closed in the mid-1980s. The population of Chapare grew from 24,000 in 1967 to almost 250,000 in 1987 (Crabtree, 2005:35). Chapare's settlers consider it their right to grow coca to earn a living but also to produce it for traditional uses such as coca leaf chewing, for products such as coca tea and toothpaste or for medical uses. Over the years the coca growers have become more and more organised and have often successfully challenged government policies on eradication. While in the beginning protest was largely limited to coca issues, coca growers have started to be involved in other economic and political issues in recent years. The MAS and Evo Morales have their background in this sector; the MAS has played a significant role in Bolivian politics since its creation in 1999. Morales received the second largest proportion of votes in the presidential elections of 2002, and was recently elected President in

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[67] Banzer's determined approach has often been interpreted as an attempt to make up for the links he had to drug traffickers during his dictatorship (1971-78). The majority of the main parties and politicians have at one time or the other been accused of links to the illegal drug industry. Thoumi argued that these links logically exist since: *"In a country with a small population and a very small elite, the illegal drug industry must penetrate the power structures to operate."* (Thoumi, 2003:257). This also helps to explain the half-hearted approach of many politicians to pursue drug eradication policies.

[68] It seems that replanting has since increased again and rose to 28,450 (EIU, Country Profile 2004:27).

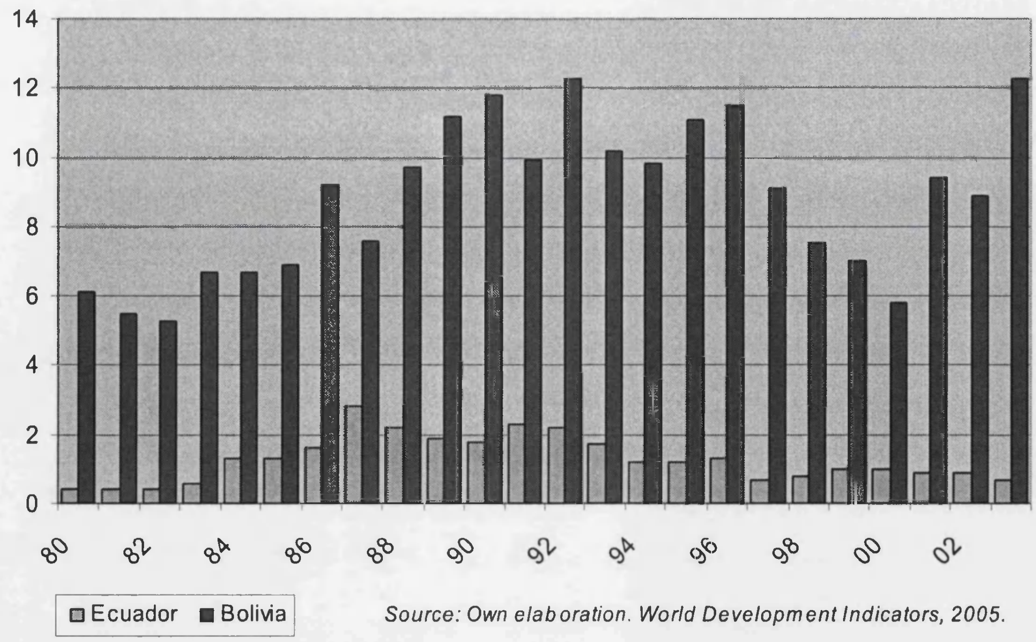
[69] The decline has other reasons as well: there was a fall in the price for coca on the international markets and other sectors of the Bolivian economy experienced growth rates during the 1990s thereby reducing the relative importance of coca earnings (Thoumi, 2003:153).

December 2005. Morales defends the rights of coca growers and promises to end all eradication programmes.

Coca has played a crucial role in Bolivia's economy which is underlined by the fact that an estimated 5 to 13.5 per cent of Bolivia's labour force is employed in this sector (Thoumi, 2003:243). The forced eradication policies of the late 1990s and their social effects on the populations of the affected regions, provide an important element for understanding the background of the increasing levels of state-society confrontations and popular protests Bolivia has experienced in recent years (see Chapter 5).

Aid. With the introduction of structural reforms from 1985 onwards, Bolivia started to receive significant amounts of donations and concessional loans from the international donor community. Foreign aid came to play an increasing role in the country's economy: while in 1985 aid represented 6.9 per cent of Gross National Income (GNI), it rose to 12.3 per cent in 2003 (see Figure 3.20). Comparing these numbers to those of Ecuador, it becomes clear that aid has played a significantly more important role in Bolivia's economy than it has in Ecuador where since 1985 aid has contributed between 1.3 and 2.8 per cent to the country's GNI and since 1997 has not exceeded 1 per cent. Confirming this difference, aid per capita ranged from US$57 to 105 in Bolivia between 1999 and 2003, and was US$12 and 17 during the same period in Ecuador (WDI, 2005).

Figure 3.20: Aid (% of GNI), Bolivia + Ecuador



Source: Own elaboration. World Development Indicators, 2005.

Conclusion

Comparing the patterns of the various economic reforms, it emerges that in most areas the two countries have proceeded very differently, while in some aspects Ecuador and Bolivia reveal rather similar patterns.

• The changes introduced in Ecuador and Bolivia concerning **public sector expenditure** make clear that Bolivia has gone quite far to abolish subsidies, mainly in one cut in 1985 and has also increased its spending on health and education. Ecuador, by contrast, has decreased its social spending and opted for a gradual approach cutting subsidies on a more or less annual basis during the 1980s and 1990s. Frequently Ecuadorian presidents had to withdraw from subsidy cuts already announced. Yet Bolivia did not succeed in reducing the number of public employees and as of 1989 numbers increased significantly; Ecuador on the other hand managed to cut central government employees during the 1990s.

• As regards **tax reforms** the two countries have proceeded rather differently. While Bolivia implemented a radical overhaul of its previously complex and inefficient tax system in 1986, Ecuador made some changes to the tax system especially since 1989 but has often done so inconsistently. Often major changes of the tax system were made only to be reversed again after some time.

• **Trade liberalisation** was one of the main elements of Bolivia's NEP. Tariffs were reduced radically in 1985 and were further lowered in subsequent years. By 1990 a tariff of 5 per cent on capital goods and 10 per cent on other imports was in place. In Ecuador, by comparison, reforms began at around the same time in the mid-1980s yet reductions were being made step-by-step and by 1991, after a new round of reforms, were still at a higher level than in Bolivia in 1985. Generally, in comparison to Bolivia's rather consistent way of tariff elimination and reduction, Ecuador was far less consistent.

• As concerns reforms of the **financial sector**, Bolivia and Ecuador both introduced a major reform at about the same time: Bolivia liberalised interest rates in 1985, Ecuador did so in 1986. The two countries have also experienced a serious crisis of the banking system in the mid-1990s, in both cases partly caused by external factors, but also revealing that financial liberalisation had not been accompanied by the setting up of an effective regulatory and supervisory framework.

• **Exchange rate policy** – although both countries decided to float their exchange rates at an early stage, in 1985 and 1986 respectively, while Bolivia consistently maintained this system, Ecuador modified and reversed its exchange rate system several times during subsequent years.

• As regards **foreign direct investment** Bolivia implemented its main reform package in 1990, with some further liberalisation in 1999; Ecuador introduced reforms more gradually, sometimes inconsistently. Crucial policies such as equal treatment of foreign and domestic firms were introduced in Ecuador in 1997, eight years after Bolivia. Both countries are facing similar constraints on attracting FDI: the limited size of the domestic market, the underdeveloped infrastructure, a shortage of skilled workers and particularly in recent years political instability.

• Bolivia did not introduce any **privatisation** reforms at all during its first years of economic reforms and ultimately developed a scheme deviating greatly from traditional privatisation concepts. Under the capitalisation scheme starting in 1995, however, most public enterprises changed hands with the private sector. In recent years privatisation processes have been increasingly criticised and may even be reversed as the nationalisation of the hydrocarbons sector is currently called for by large sectors of the society. Ecuador, meanwhile, has introduced some pro-privatisation legislation ever since the mid-1980s. Yet despite these laws very few state-owned enterprises have actually been transferred to the private sector; in addition, Ecuador has increased the state's control over the oil production sector.

• As concerns **social security**, Bolivia has implemented a wide-ranging structural reform of its pension system replacing the former pay-as-you-go scheme. In Ecuador no structural reform has been introduced so far.

While the patterns differ depending on the specific subject, in many cases Ecuador has introduced *Washington Consensus* reforms rather late and often in an inconsistent way throughout the 1980s and 1990s. Bolivia on the other hand has – with exceptions such as public sector employment – managed to introduce rather wide-ranging reforms consistently and at an early stage. Given that tax reform represents a good example for this pattern, it has been chosen as a case study for this thesis. Focusing on one area of economic reforms enables the consideration of policy-making processes in greater detail; at the same time it is assumed that an analysis of tax politics will provide insights into patterns of policy-making in these two countries more generally. The question asked in the subsequent chapters is:

Why have Bolivian presidents managed to introduce comprehensive tax policies during the 1980s and 1990s? For what reason have Ecuadorian presidents, by contrast, often failed to introduce the reforms intended?

After this and the previous chapter gave an overview of the political structures and the economic policies, we will now move on to the tax reforms introduced in Ecuador and Bolivia during the last two decades. In the course of this analysis it will become clear that the variations in institutional structures of the two countries influenced tax policy-making processes and can help answering the questions above.

4 Bolivia: Tax Reforms during a Period of Coalition Politics – The Government of Paz Estenssoro, Paz Zamora, and Sánchez de Lozada (1985-1997)

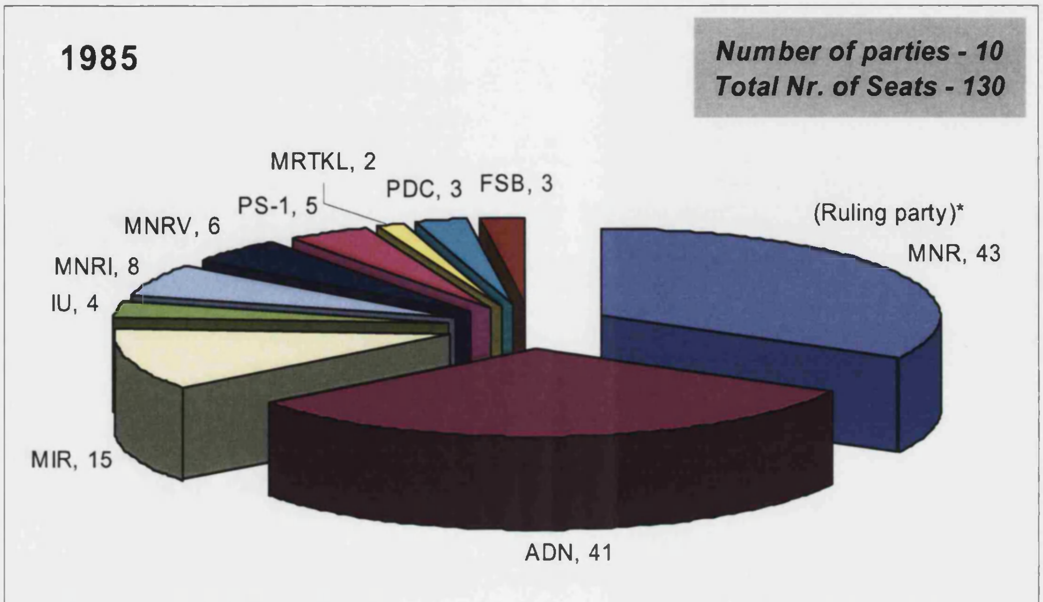
4.1 The Government of Siles Zuazo (1982-1985)

Though no attempt to introduce changes to the tax system was made during the presidential period of Siles Zuazo, a short outline of the period of this government will be given here to facilitate an understanding of the dynamics of policy-making in the succeeding Paz Estenssoro period. When Siles Zuazo came to power in 1982, he was supported by a coalition of the *Unión Democrática Popular* (UDP), which was rather heterogeneous and went through a lot of internal arguments and disagreements which in turn made governing and responding to the economic crisis with coherent and wide-ranging policies difficult. As Juan Cariaga, who was to become a key figure in the economic team of the subsequent government, pointed out all the attempts made by the government to counteract the growing economic crisis basically failed because it was a minority government and many policy initiatives were blocked by the opposition – MNR and ADN – in Congress, and also as Bolivia's main trade union, the *Central Obrera Boliviana* (Bolivian Workers' Confederation, COB), managed to pressure the government into considerable concessions (Cariaga, interview, 21.5.2004).

Consequently, the government was too weak to reduce the state's expenditures, to devalue the real exchange rate adequately, and to improve tax collection – measures which would have helped stabilise the Bolivian economy. In consequence, Bolivia increasingly lacked both internal and external income: internal as tax collection rates fell drastically reaching a level of only 15 per cent of government spending in mid-1985 (Lynch 1994a:103). Foreign lending had practically come to an end in the aftermath of 1982 due to the debt crisis and the unreliable political and economic situation in Bolivia. Facing this lack of income and given the inability to cut public spending, the Siles Zuazo government took to the printing press. In consequence, Bolivia went through a process of hyperinflation in 1984-85, reaching an annualised inflation rate of 11,749.6 per cent in 1986 (see Appendix D). Hyperinflation not only destroyed the savings of Bolivians, it also decreased the already low tax income further. According to Carlos Otálora, Executive Director of the Internal Revenue Service in 1983, 80 per cent of the fiscal deficit in 1985 was financed by monetary emissions (Otálora, interview, 12.5.2004). The fall of world market prices for tin, Bolivia's main export product, further aggravated the economic crisis.

4.2 The Government of Paz Estenssoro (1985-1989)

Figure 4.1: Composition of Lower Chamber 1985, Bolivia



Source: Own elaboration. Data from www.observatorioelectoral.org

** Ruling party here denotes the party of the president.*

Change of government. Faced with more and more calls for his resignation, President Siles Zuazo agreed in November 1984 to shorten his term by one year and to call for elections in 1985. The first round of the elections of 1985 was won by Hugo Banzer Suárez, the army general who had ruled the country in the years 1971-78. While Banzer from the ADN gained 32.8 per cent, Víctor Paz Estenssoro, head of the MNR and leader of the revolution in 1952, came second with 30.4 per cent. He had been president already in 1952-56 and 1960-64 and is one of Bolivia's leading figures of the twentieth century. As he had previously supported state-led development, his introduction of wide-ranging structural reforms came as a surprise to many of his supporters (see next section for reforms). Jaime Paz Zamora of the centre-left MIR, who had been Vice-president under the UDP government, ended up in the third place having won 10.2 per cent of the votes (CNE, 2005a).[70] The subsequent second round of elections took place in the Congress, where its members had to choose from among the first three candidates as prescribed by the Bolivian Constitution in Article 90. The MNR managed to gain the

[70] As Vice-president of the previous government Paz Zamora would constitutionally not have been allowed to stand as a presidential candidate in these elections. However, in exchange for agreeing to breach the Constitution – which would have required him to take charge in the case of the president's resignation and by calling for early elections instead – Paz Zamora asked for a second constitutional breach allowing him to be a presidential candidate in the 1985 elections (Paz Zamora, interview, 19.5.2004).

support of the MIR – who at that time was not willing to vote for Banzer under whose military dictatorship many of its leaders had been persecuted – and Paz Estenssoro was elected President. During his government ten parties were represented in the lower house of the Congress with the three main parties – MNR, ADN, and MIR – taking more than three-quarters of all seats.[71]

Though the MIR had supported Paz Estenssoro to become President, no ruling coalition between the MNR and MIR was set up and Paz Estenssoro started without a coalition partner after his inauguration in August 1985. Attempts to stabilise the disastrous and ever worsening economic situation became the main priority and soon after coming to power the government introduced drastic economic measures.

Decree 21060. Immediately after taking office Paz Estenssoro put together a small team of economic experts around Gonzalo Sánchez de Lozada to develop an economic emergency programme in the shortest time possible. On 29 August, 1985 the President introduced the New Economic Policy (*Nueva Política Económica,* NEP) via Decree 21060. The main elements were: a) the peso was devalued by 93 per cent which brought an end to the artificial maintenance of the exchange rate and allowed the treasury to save the money previously spent on this; b) with few exceptions all consumer price subsidies were eliminated; c) foreign currency bank deposits were allowed, at free interest rates; d) labour laws were liberalised; e) government spending was reduced, for example, salaries of government workers were frozen between August and December 1985; f) unprofitable mines were closed and around 20,000 miners (out of 30,000 in total) laid off; g) the economy was opened up to foreign trade and to international movements of capital (Lynch 1994a:104-5; Jameson 1989:95-97; Conaghan 1994:255). All these measures were introduced by decree and thus came into force immediately as approval from Congress was not required. Bolivian presidents only have the constitutional right to introduce regulatory decrees which modify existing laws but cannot create new laws (see Chapter 2.2). As pointed out by Juan Urioste, constitutional adviser to the economic team formulating Decree 21060, great care was taken to use the decree as prescribed by the Constitution and all changes introduced represented modifications to existing laws (Urioste, interview, 11.5.2004). Given the wide-ranging changes contained, introducing these by decree probably still meant stretching the rules a bit. Once implemented hyperinflation was ended almost overnight: while the monthly inflation rates had been 66.5 per cent in August 1985 and 56.5 in September, in October

[71] For some background information on these and other parties see Appendix F.

it was -1.9 per cent (INE, 2005). Seen on an annual basis inflation went from 11,749.6 per cent in 1985, to 276.3 in 1986 and 14.6 in 1987 (see Appendix D).

Coalition with the ADN. While President Paz Estenssoro was thus able to introduce wide-ranging economic measures via decree it was clear that in the long run he would need a coalition partner to be able to govern successfully and have his policy initiatives approved. The tax reform already on the government's agenda would undoubtedly need to be introduced by law and thus required a vote in Congress. Soon after the introduction of the economic stabilisation measures, Paz Estenssoro started negotiations with ADN leader Hugo Banzer who subsequently decided to enter into a coalition with the MNR.

"After Paz Estenssoro was elected President and when he realised that the introduction of economic stabilisation measures would be very hard and could generate a response, a popular opposition of great magnitude, he realised that he needed the support of the Parliament, he needed to create governability and it is then that he convokes General Hugo Banzer Suárez for meetings and proposes to sign the Pacto por la Democracia and they sign a Pacto por la Democracia." (Pacheco, interview, 5.5.2004)

The *Pacto por la Democracia* (Pact for Democracy), signed on the 16th of October, was to last for almost four years and provided Paz Estenssoro with sufficient partisan support to introduce his reform proposals. The MNR and ADN together held 84 of the 130 seats in Congress, which amounted to a comfortable majority. Banzer and the ADN largely agreed with the economic measures taken by Paz Estenssoro – in fact the same Juan Cariaga who was part of the economic team behind the Decree 21060 had developed an economic policy programme for Banzer during his election campaign. According to Cariaga the programme written for Banzer and the 21060 shared a lot of common ground (Cariaga, interview, 21.5.2004). Thus there was a considerable degree of overlap in the approaches of both parties towards improving the economic situation of Bolivia which facilitated the creation of this coalition. This first coalition, therefore, deviates from the pattern that electoral coalitions pass into government coalitions – it was only formed after the President was elected in Congress. The necessity to overcome Bolivia's economic and political crisis has provided an incentive for co-operation in this situation. Although the *Pacto por la Democracia* did not involve the sort of power-sharing agreements the subsequent coalitions would, it was also based on the distribution of patronage: for a certain time period the ADN received the leading positions in several state agencies and corporations. In addition it was secretly promised that the MNR would support the candidacy of Banzer in the next election (Malloy, 1991:51; F. Romero, interview, 25.5.2004). However, in the run-up to the elections, Sánchez de Lozada – the successor to Paz Estenssoro as the leader of the MNR – decided to stand for the presidency himself and broke this informal agreement between MNR and ADN.[72] This was to have a lasting effect on relations between the two parties and the ADN left the coalition a few months before the presidential elections in 1989, after it had become clear that Sánchez de Lozada would present himself as a candidate. Despite this unhappy ending, what had started as a political experiment in 1985 turned out to be a very successful coalition providing Bolivia with a period of political stability and a coherent introduction of economic policies.

The Tax Reform of 1986

In early 1986 President Paz Estenssoro embarked upon reforming the no longer functioning tax system in order to consolidate the income side of public finances. This complemented the stabilisation measures of the previous August which had made considerable cuts in public spending. Once again he set up a small economic team around Sánchez de Lozada (then Minister of Planning), Juan Cariaga (then Minister of Finance) and Ramiro Cabezas (Minister of Tax Collection 1986-87) that was to be in charge of developing a proposal for tax reform in a relatively short time period. On the 19th of March, the Paz Estenssoro government submitted its tax reform proposal to Congress and by the 20th of May it was approved by the legislature.

Main elements.[73] The tax reform approved in May 1986 represented a complete overhaul of the previously complex tax system. Several hundred taxes were abolished and replaced by only six; revenue generation and administrative simplicity were the guiding principle for the new tax system (Mann 1990:33). Eduardo Antelo, economist and later Vice-minister of the Treasury, summarised the essence of this tax reform:

"Law 843 was a simplification of the tax system. The number of taxes was reduced and it basically changed to indirect taxes based on consumption, which are administratively a bit easier to control so that collections could be increased. This new system was strongly based on taxes like the VAT." (Antelo, interview, 24.5.2004)

At the heart of the new structure was a *Value-added Tax* (VAT): over 400 sales taxes were combined into a unified 10 per cent VAT. A wide range of exemptions was abolished. The new system eliminated all income taxes; the Personal Income Tax was

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[72] Apparently, Paz Estenssoro strongly opposed this decision of Sánchez de Lozada and wanted to fulfil the agreement with Banzer (F. Romero, interview, 25.5.2004).

[73] See Appendix G for an overview of Bolivia's tax system between 1986 and 2004.

replaced by a *"Complementary Tax"* to the VAT. This 10 per cent withholding tax on all income could be reclaimed on the presentation of invoices up to the amount withheld (thus providing an incentive for people to ask for invoices). A *2 per cent Tax on the Presumed Profits of Companies* was introduced instead of the Corporate Income Tax as it was easier to administer. The *Property and Vehicle Tax* ranged from 0.15 to 2.65 per cent for the presumptive income generated by real estate and 0.5 to 4 per cent for vehicles. A 1 per cent *Transactions Tax* on sales and other transfers of property was introduced, covering sales of goods and services such as rents, professional fees, sales of shares, real estate properties, motor vehicles, aircraft, also transfers of property at death or by gift. The *Special Consumption Tax* (also excise tax) represented another indirect tax imposed on alcoholic beverages, tobacco products, perfumes, cosmetics and jewellery at rates of 30 to 50 per cent. Some changes to the *tax administration* were also implemented, among them: the payment of taxes was now processed via the banking system and the Internal Revenue Service was re-organised. The tax reform established a scheme of *"co-participation"*: 75 per cent of all tax revenues would go to the central government, 10 per cent each to the departments and municipalities, and 5 per cent to the universities.[74] Finally, a *tax amnesty* was declared, allowing taxpayers to pay a one-off tax for having their tax obligations until 31 December, 1985 forgiven.[75]

Table 4.2: Main Elements of 1986 Tax Reform

Tax Reform of 1986
1) 10% VAT
2) 10% "Complementary Tax"
3) 2% Tax on the Presumed Profits of Companies
4) Property and Vehicle Tax: Property (0.15%-2.65%); automobiles, boats and airplanes (0.5%-4%)
5) 1% Transactions Tax
6) 30%-50% Excise Tax on cigarettes, alcoholic drinks, jewellery and cosmetics
7) Changes to the Tax Administration
8) "Co-participation"
9) Tax Amnesty

Source: Own elaboration.

[74] This aspect was added during the executive's negotiations with the coalition partner ADN.

[75] For more information on the elements of the 1986 reform, see Appendix E.

The taxes outlined in Table 4.2 constitute the main elements of the new tax system introduced in 1986 by Law 843, bringing *"one of the simplest tax systems in the world"* into existence in Bolivia, according to tax lawyer Álvaro Villegas (Villegas, interview, 28.5.2004).

Opposition to the reform. After the bill was made public in March 1986 and while it was discussed in Congress, criticism and opposition came from several sides. As regards political parties, opposition came mainly from the third-biggest party in the legislature, the MIR, which questioned the bill as pointed out by the party's leader Jaime Paz Zamora:

"We saw the need for a tax reform and for simplifying the tax system ... and we believed that this was positive, but we thought that its concept of universality was not equitable. Therefore, we criticised this issue, we did not criticise the simplification but we criticised the concept of universality." (Paz Zamora, interview, 19.5.2004)

To provide an alternative for discussion the MIR submitted its own tax reform proposal to the Congress. Their project was a lot more progressive in its character and contained a higher number of exemptions to the VAT on basic articles and services. They also put the main focus on improving the administration which they saw at the heart of the problem: the tax base had been destroyed by the process of hyperinflation (which would have destroyed any tax base) (*El Diario*, 3.5.86:4). Most of the other smaller congressional parties – as for example the MNRI (*Movimiento Nacionalista Revolucionario de Izquierda*) and PDC (*Partido Demócrata Cristiano*) – agreed with the MIR and equally rejected the tax reform. Despite the criticism of the specific proposal outlined by the government, most political parties agreed that some sort of tax reform was necessary. Outside the institutional political arena, the COB mobilised against the plans; several local Civic Committees issued statements against the tax measures before meeting as the National Conference of Civic Committees, which mainly criticised the centralist and regressive nature of the proposed changes (*El Diario*, 7.5.86:8;10.5.86:1;11.5.86:1).

Protest was also strongly voiced from the municipal level as mayors criticised the abolition of many small taxes whose income was part of their budgets (*El Diario*, 22.3.86:7). They feared loss of resources and argued that the autonomy of town councils would be undermined. An extraordinary meeting of town councils was held in early April in Cochabamba where the potential effects of the tax reform on the municipalities were discussed and which concluded with a public statement rejecting the bill (*El*

Diario, 2.4.86:3;14.4.86:2). After some modifications were made to the law during the government's discussions with the ADN (see next section) the bill had lost much of its previous centralist character. The municipalities were actually no longer disadvantaged by it as some local taxes were maintained and they would receive compensation for the ones to be abolished. Even after these changes, however, the mayors and town councils of Bolivia reiterated their criticism of the project and in early June even reissued their April statement (*El Diario*, 9.5.86:8; 14.5.86:7; 7.6.86:7).

With respect to the private sector, criticism came from the *Confederación de Empresarios Privados de Bolivia* (Bolivian Private Entrepreneurs' Federation, CEPB), though signals were mixed as parts of the CEPB supported the measure while others tried to prevent it (*El Diario*, 6.4.86:4). According to Sandra Romero, current deputy manager for tax issues at the *Cámara Nacional de Industrias* (National Chamber of Industries, CNI), the Chamber disapproved of particular elements of the project pointing out especially the negative effects the planned Tax on the Presumed Profits of Companies would have on investments. On a similar line, the current manager of the CNI, Gerardo Velasco, explained that the business sector disagreed with the 2 per cent corporate tax and the 1 per cent Transactions Tax that the government's project entailed:

"We tried to influence so that these two would not be introduced, or introduced but in a different way. For example, we said that we should pay one third of the tax on presumed profits, which was at a rate of 2 or 3 per cent, as it obviously represented a punishment for investment." (Velasco, interview, 27.5.2004)

Their demand, however, was not answered and the taxes remained as set up in the original proposal.

Consensus reached with the ADN. The government largely ignored the various concerns of the different political parties and sectors of society and instead focused on reaching an agreement with its coalition partner. A series of meetings between the MNR and ADN were held to reach a consensus on the project. Banzer's ADN, had several objections to the tax reform and criticised especially its *"centralist spirit and its anti-constitutional essence contradicting the town councils' autonomy"* (ADN leader Alfredo Arce in El Diario 15.6.86:3). In the course of the negotiations with the MNR, the ADN managed to have its suggestions included. The principal changes to the original project were:

a) the executive would not be delegated the right to modify tax rates (as the original project provided for);

b) the resources of the municipalities would not be affected; they would continue to receive the income of the vehicle and property tax. In addition they would get 10% of all taxes collected in their department, which represented a higher amount than what they used to obtain from the municipal tax on sales and transfers which was to be abolished;

c) universities would be allocated 5% of the total collection in their department. The original proposal had entailed a lower allocation (*El Diario*, 30.4.86:3;1.5.86:1; 9.5.86:1).

While these changes modified the tax bill, these changes were not major. Having thus reached a consensus, the project was jointly endorsed.

Tax reform approved. When the coalition partners MNR and ADN had reached the agreement, President Paz Estenssoro made use of his power to convene an extraordinary Congress, as provided by the Bolivian Constitution in Article 95,5. After several rounds of discussions the bill was approved by the Senate without any significant changes on the 20th of May, after the lower house had approved it on the 17th of May. Though the smaller parties in the lower house – PS-1, MRTKL (*Movimiento Revolucionario Tupac Katari de Liberación*), MNRI and FSB (*Falange Socialista Boliviano*) – tried to prevent the new law and left the plenary when it came to voting to demonstrate their opposition to the bill, their manoeuvres made no difference as the tax reform was approved with the votes of MNR and ADN in both chambers. While the tax reform was thus decided upon and was to come into force on the 1st of August, the discussions did not stop there. The COB continued to protest against the tax measures, arguing that the workers would bear the highest burden; they even organised a consultation on the issue in late July in which 95 per cent of the 300,000 voters opposed the reform (EIU, 1986:18). Generally, however, the referendum was considered to be rather irrelevant, partly as it came at a time when the reform was widely accepted or simply was not on people's minds any longer, and partly because the number of people the COB mobilised to participate in the referendum was rather limited. The government reacted to the continued criticism coming from different sectors of society, by putting a series of advertisements into the main newspapers of Bolivia in the aftermath of the decision. These advertisements explained the reform's principal elements and the necessity of its introduction (El Diario, 25.5.86:3). Ministers of the Cabinet also organised press conferences to respond to questions and a campaign to inform about the advantages of the reform was carried out in the rural areas of the country (El Diario, 15.6.86:12;11.6.86:3).

Why was the Reform Possible?

The tax reform of 1986 represented a complete overhaul of Bolivia's tax system, one of the most far-reaching in Latin America at the time. Tax collection had declined steeply during the decade preceding the reform, and came close to total collapse in the process of hyperinflation. The reform thus almost started from zero and while the tax rates were not very high when compared to other systems, one has to bear in mind that for Bolivians the tax reform largely meant resumption of any tax payments at all. Considering this, why did the President manage to have this reform introduced?

Hyperinflation. The most obvious answer to this question is to refer to the process of hyperinflation Bolivians had gone through, which made them willing to accept wide-ranging economic measures in order to bring an end to, or avoid returning to, the traumatic experience the country had experienced in 1984-85. Fernando Illanes, Finance Minister in 1993-94, when asked why the reform was possible answered on this line:

"Because Bolivia had reached the bottom with the hyperinflation, the people accepted anything which would mean leaving this process of hyperinflation, which is a process that is cruellest for the poor people because it is them who suffer most from devaluation... It was a moment in history which allowed that the population generally accepted drastic changes." (Illanes, interview, 4.5.2004)

A similar argument, namely that the Bolivian society accepted the 1986 tax reform due to their desire to overcome the experience of hyperinflation, was expressed by a large number of interview partners (Antelo, Candía, Cabezas, Felix, Millares, Otálora, Pereira, Doria Medina, Urioste, interviews, see Appendix B for dates). This willingness to accept partly rather harsh economic measures was already seen when in August 1985 an economic reform package was implemented via Decree 21060. However, at that time Bolivia was at the peak of the hyperinflationary process, which then had been brought to an end by the economic stabilisation measures of the same 21060, which caused inflation rates to tumble. At around the time of the tax reform in April 1986, the inflation rate stood at only 166 per cent (El Diario, 18.4.86:5), which is still high but low compared to the numbers of just a year earlier and on the decline. While hyperinflation was now over it still represented a recent experience that continued to be on the minds of Bolivians, increasing their support for the new tax system. Francisco Muñoz of *PriceWaterhouseCoopers* expressed this fear:

(Inflation) *"had lowered but not disappeared. The danger was a return to hyperinflation... You could not run the risk of not creating a tax system and have hyperinflation return; the people were terrified of this hyperinflation, so this issue had to be resolved thoroughly."* (Muñoz, interview, 11.5.2004)

The government was quite aware of the potential the fear of a return to hyperinflation could have and used it for gathering support for the tax reform among the Bolivian population. The tax reform would mean the *"definitive defeat of the hyperinflationary process"* said Javier Campero Paz, Executive Secretary of the MNR; and both President Paz Estenssoro and Minister of Planning Sánchez de Lozada referred repeatedly to the necessity of the tax reform for preventing a return to hyperinflation (*El Diario*, 9.5.86:1;18.3.86:1;20.3.86:1; 21.3.86:1). Members of the government recurrently exploited the hyperinflation argument to demonstrate the need for reform whenever they publicly explained or defended the proposed tax bill. As entrepreneur Doria Medina pointed out the experience of hyperinflation provided a window of opportunity: *"There had been so many problems with hyperinflation that an opportunity opened up to make important changes."* (Doria Medina, interview, 25.5.2004). Hyperinflation thus appears a crucial factor in making the tax reform of 1986 possible.

Initial success and legitimacy. Apart from hyperinflation other variables played a role in facilitating the tax reform. The government's economic measures so far had been quite successful; in particular, they managed to bring an end to hyperinflation soon after coming to power. In consequence, society had started to trust President Paz Estenssoro as he had already managed to deal with a crucial economic challenge at the beginning of his government. Juan Antonio Morales, President of the Central Bank since 1996, commented:

"The government could do this by taking advantage of the boost they had received from their success in stabilisation... It is a reform which came in consequence of a crisis and the initial success which the government had in stopping inflation." (Morales, interview, 24.5.2004)

The government's initial success thus boosted social support for its other economic measures. Partly as a consequence of this success, the government of Paz Estenssoro had a lot of legitimacy and was therefore able to go ahead with its economic policies. A survey carried out in June 1986 gave very positive results about the achievements of President Paz Estenssoro so far and showed that 74.7 per cent of the people thought that the President had *"earned a lot of merit"*.[76] Tax expert Eduardo Villegas considered this aspect of legitimacy as crucial in the case of the 1986 tax reform given that there had actually been considerable opposition to it from various sectors.

[76] The survey was carried out by „Encuestas y Estudios", a La Paz-based research institute. 13,000 people in various parts of the country were interviewed on the 17th of June (*El Diario*, 1.8.86:1).

"We cannot say that the tax reform has been received that favourably, it has been subject to various struggles on the street, it has not been that simple at that moment. However, the President at that time had a lot of legitimacy, and implemented a solution." (Villegas, interview, 28.5.2004)

Emergency power. Between 1985 and 1989 President Paz Estenssoro made use of his constitutional power to declare several states of emergency, which were supported in Congress by the MNR and ADN. During the state of emergency the government banished hundreds of trade union leaders, among them COB leader Juan Lechín. These repressive measures diminished the protest potential of Bolivia's principal trade union significantly. In addition, the COB had lost much of its convocational power as they had been discredited because many people saw them as partly responsible for the political and economic instability of the Siles Zuazo period. Some of the economic measures of the Paz Estenssoro government also reduced the base of COB members, for example as around 20,000 miners were fired, a process that Juan A. Morales called the *"coup de grace to militancy"* for the COB (Morales 1991:37). According to Maria Felix, tax analyst of the governmental research institute *Unidad de Análisis de Políticas Sociales y Económicas* (Unit for the Analysis of Social and Economic Policies, UDAPE*)*, the government could introduce this tax reform and other economic policies because they managed to reduce the protest potential of the COB. President Paz Estenssoro took hold of its principal leaders and confined them to another province (Felix, interview, 30.4.2004). He was able to do this given the state of emergency that he had declared.

External influence. External influence seems to have played a limited role: though multilateral organisations put some pressure on Bolivia to lower its fiscal deficit, no suggestions were made as to how this should be done. Apparently both the World Bank and the IMF were not even particularly supportive of the tax reform in the beginning (Mann, 1989:386). Those who developed the reform were all Bolivian.

Coalition. For the reasons outlined above, most Bolivians accepted the restructuring of the tax system as there was a widespread feeling that something had to be done and that a complete overhaul was necessary. While popular support triggered by the experience of hyperinflation was crucial, the coalition that existed at governmental level constituted a complementary element providing the President with sufficient support in the institutional arena to get the reform approved. It is less easy to explain, by variables such as hyperinflation and others, why the reform proposed by the government went through without any significant changes. The dynamics taking place at the politico-institutional level seem more relevant in accounting for this.

As outlined earlier a considerable degree of opposition to particular elements of the reform existed both inside the Congress and outside the political arena. Several political parties, such as the MIR and some of the smaller parties represented in Congress, criticised the regressive character of the reform and were in favour of allowing more exemptions to the VAT (for example on basic food items, to protect people on low incomes). The COB also criticised the regressivity and the municipal governments thought the reform too centralist and feared that their tax income would be reduced.[77] The private sector, mainly represented by the CEPB and the CNI in this discussion, tried to influence the legislation concerning the tax on companies and the Transactions Tax. Notwithstanding this opposition to various elements of the reform, the bill went through without any significant changes. The only modification that took this criticism into account were the provisions regarding financial resources and tax collection which had been revised during the negotiations between ADN and MNR and which appeared to accommodate protests against the centralist nature of the reform. Apart from this change, however, all other demands remained unmet. Napoleón Pacheco, Director of the prominent research institute *Fundación Milenio*, evaluated the process as follows:

"I believe the new President Dr. Paz rescued (the country, SL) from a bad experience and what he did was forming a political alliance with the principal party of the opposition, which at that moment was the ADN. And from this moment starts what is called the politics of consensus, of pacts which allow the government to have a majority in the Parliament and can thus generate the conditions for governability. I believe that this is the politically crucial element which allowed the government of Dr. Paz Estenssoro to approve an evidently extremely complicated tax reform because - although technically there were a lot of reasons to support a tax reform - if they had not had a consensus, the pact in the Parliament, probably it would not have been approved." (Pacheco, interview, 5.5.2004)

The government was able to introduce this tax reform as they saw fit because of the coalition that existed between the ruling party MNR and Hugo Banzer's ADN. The two parties combined held a comfortable majority of 65 per cent of the seats in the Congress, which meant that once MNR and ADN agreed on an economic policy it was as good as implemented (apparently, the members of both parties generally voted with their leaders). Like Pacheco, Juan Cariaga was convinced that without the coalition between ADN and MNR the tax reform *"would not have been possible"* (Cariaga, interview, 21.5.2004).

[77] At least after the modifications introduced during the MNR-ADN negotiations the tax reform did not actually reduce the income of municipal governments. However, this fear remained and the municipal governments maintained their opposition to the reform.

In 1986, however, such a drastic tax reform was possible due to the recent experience of hyperinflation and social desire for stability, and the existence of the coalition between the MNR and ADN, which provided President Paz Estenssoro with sufficient partisan support to introduce the reform without major changes. The combination of popular support and coalition politics proved decisive in the successful approval of this tax reform.

Effects. As regards the effects of the reform in economic terms, tax collection increased ever since inflation was tamed, and further progress was made after the 1986 reform was introduced. Internal revenue tax collections increased from 2.32 per cent of GDP in 1985 to 7.27 in 1988 (Cariaga, 1997:117; see also Chapter 3.2).

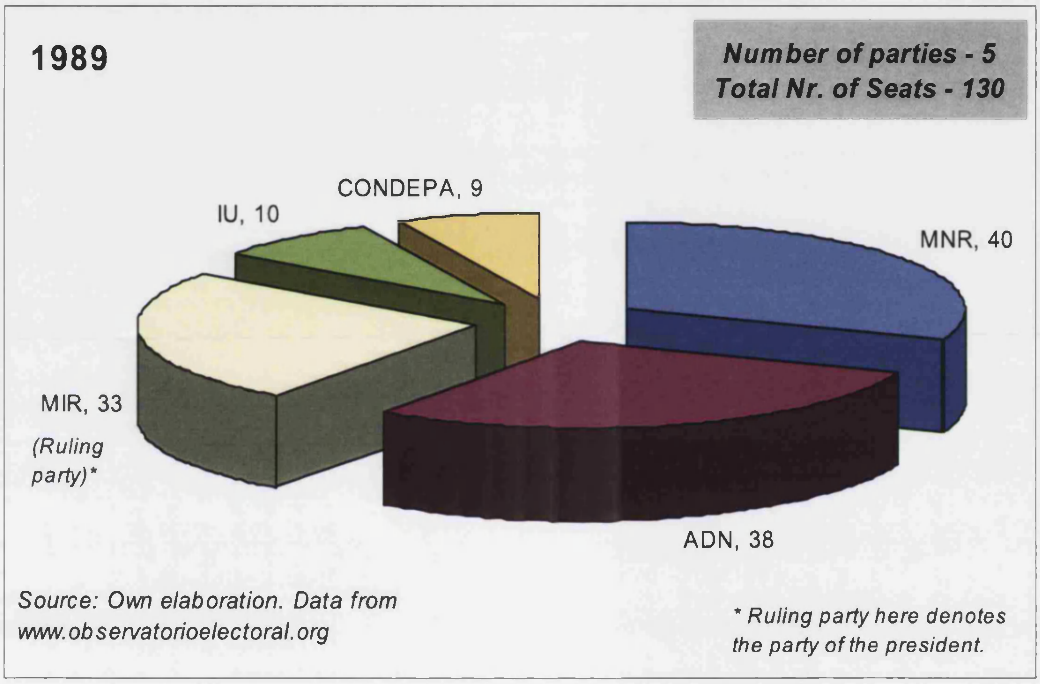
4.3 The Government of Paz Zamora (1989-1993)

During the presidential election of May 1989 Sánchez de Lozada's (MNR) strategy – to run himself rather than leave the presidency to the former coalition partner and as had been agreed – seemed to have paid off. He gained the highest number of votes with 25.7 per cent. Banzer closely followed with 25.2 per cent and Jaime Paz Zamora (MIR) gained 21.8 per cent (CNE, 2005a). Several months of intensive negotiations followed during which the isolation of the MNR became more and more apparent. The breaking of the agreement had led to a complete estrangement with the former coalition partner ADN and Sánchez de Lozada's aggressive election campaign left him unable to find any political allies for the second round of the election. By the time this took place in Congress in early August, an unlikely deal was struck: the ADN formed the so-called *Acuerdo Patriotico* (Patriotic Accord) with the MIR to support Jaime Paz Zamora in his bid for the presidency. Seen in the context of the recent Bolivian history the co-operation of these two parties was rather unexpected: during the military dictatorship 1971-78 of General Banzer many members of the MIR, including Paz Zamora himself, were persecuted, exiled, or even murdered. Paz Zamora explained in an interview how this unlikely alliance came about:

"I believe this happens in politics, it happens in love and in everything, sometimes the adversaries become so adversarial that they respect each other. Or put otherwise, we had confronted each other so much and they knew that we had confronted each other in unequal conditions, being underground, that there was respect. There was credibility, so that I could say they are from the right but I can trust them when they give their word, and they said they are from the left but we can trust their words." (Paz Zamora, interview, 19.5.2004)

Be it for these reasons or because of the lack of political alternatives, the MIR and the ADN joined forces and on 6 August, 1989 Jaime Paz Zamora – who only came third in the popular vote – was elected Bolivia's President by the Congress for the period of 1989-93.[78] The *Acuerdo Patriotico* lasted throughout the whole governmental period of Paz Zamora and, as with the *Pacto por la Democracia*, provided the President with sufficient partisan support to have his policies implemented and to govern in a coherent way.

Figure 4.3: Composition of Lower Chamber 1989, Bolivia



Distribution of power in Congress. The lower chamber of Congress that was installed in 1989 had only five parties represented in it, the lowest number ever since Bolivia's return to democracy. As in the previous legislative period three parties dominated in the legislature: MNR, ADN and MIR. The *Conciencia de Patria* (CONDEPA) which was founded by the radio and television presenter Carlos Palenque and which had its support base mainly in the Aymara-speaking population of La Paz and El Alto, was a newcomer to the Congress. CONDEPA presented itself as an alternative to the traditional parties and lobbied against neoliberal economic policies. Between the two coalition partners,

[78] At that time the Constitution still provided for the Congress to choose from among the three most voted candidates of the first round. As from the presidential elections in 1997, the Congress chose between the first two.

the MIR and the ADN held 71 out of the 130 total seats in the lower chamber of the Congress.

Patronage. The MIR and ADN-led government did not succeed in its aim to cut public spending and public sector employment even increased, which had partly to do with the nature of the *Acuerdo Patriotico*. The distribution of patronage turned into an essential element to keep the coalition going. The ADN-MIR coalition controlled the executive branch together and governmental positions were shared between them: the ADN held ten ministries including some of the most influential ones such as Finance, Defence, and Foreign Relations. According to Lazarte, three new ministries, 16 undersecretaries, and 20,000 new positions in the public sector were created during the government of the *Acuerdo Patriotico* (Gamarra, 1992:34). In part these handouts of jobs were used as a way to reconcile members of Paz Zamora's MIR itself, given their opposition to many of the liberal economic policies undertaken which they saw as contradicting their political ideology. On the other hand, coalition partner ADN demanded its share of positions to maintain its support for President Paz Zamora. While patronage as an instrument to create and uphold a governmental coalition had become more important during the Presidency of Paz Zamora, it seems to have been an inherent element of all Bolivian coalitions that existed since 1985 and of political dynamics in Bolivia more generally (Gamarra, 1994:122).

Economic policies. In his election campaign Paz Zamora had criticised the neoliberal economic policies introduced by Paz Estenssoro and had announced he would change the *New Economic Policy*. On coming to power, however, his rhetoric and policy position changed and he announced that: *"Plans for national growth and well-being will be based on what has been achieved by the past administration"* (quoted in Lynch, 1994a:112).Throughout his term, then, Paz Zamora continued and extended the NEP introduced by Paz Estenssoro and stuck to the market-oriented model. Some even considered his reforms more orthodox than those of his predecessor (Morales, 1994:312). In January 1990 the *Acuerdo Patriotico* government launched Decree 22407 which largely ratified the main elements of Paz Estenssoro's *New Economic Policy*. Advances were made particularly in the area of trade liberalisation as all non-tariff barriers to trade were eliminated, import tariffs were reduced and incentives for private investment were created by new legislation introduced in 1990 and 1991 (Van Dijck, 1998:36). Major structural economic measures, however, were not introduced during this governmental period.

Given the gap between Paz Zamora's election campaign and the policies he eventually introduced, he had undertaken a clear reversal of his policy position. As pointed out by Stokes (2001:92), the MIR's minority status can largely account for this policy switch. As mentioned above, the coalition partner ADN held the majority of the ministries, including the most important ones, and obviously dominated the ruling coalition. It is therefore no surprise that the policies adopted come closer to those traditionally advocated and already supported in the previous governmental period by the ADN.

Social conflicts and states of emergency. The amount of protests and social conflicts was significantly lower than during the previous government's term: while Ballivian (1999:39) accounts for 506 strikes between 1986 and 1989, there were only 109 during the years 1990-93. In part this reduction was simply a result of the continuing decline of the trade union movement's power, in part it was due to the repressive measures that had been undertaken by Paz Estenssoro and were now continued by President Paz Zamora. Only a few weeks after coming to power, the *Acuerdo Patriotico* implemented a state of emergency in response to a teachers' strike and then used this time period for arresting union leaders and forcing them to go into exile to other parts of the country (Morales, 1994:131; Gamarra, 1994:112).[79]

Tax Reforms during the Paz Zamora Government

The first change to the tax system during the Paz Zamora government was introduced in February 1990 when a law was approved that increased the rate of the Transactions Tax from 1 per cent to 2 per cent (*Ley* 1141, 23.2.1990). This case of tax legislation, however, will not be analysed and the case study considered from Paz Zamora's presidential period is the 1992 tax bill which increased the VAT rate to 13 per cent. Both these tax laws where ultimately approved without any modifications made to the original proposal of the executive and the process surrounding their introduction was rather similar, which makes it sufficient to consider only one of the two. In terms of scope and potential tax collection an increase of 1 per cent in the Transactions Tax and a 3 per cent increase in the VAT rate are more or less comparable. Yet VAT is a tax that is much more visible to people and can thus be expected to trigger more opposition

[79] The Bolivian Constitution requires the Congress to approve states of emergency implemented by presidents. Since the *Acuerdo Patriotico* did not count on a two-thirds majority required to do so, however, and since it was unlikely any other party would support such a measure, the government used its majority in the legislature to impose a congressional holiday during the time of the state of emergency. The decision on this recess was taken without having reached a quorum, due to which the government was later accused of unconstitutional behaviour (Gamarra 1994:112,125).

when raised than an increase in the rate of the transactions tax, which is usually mainly contested by the private sector. A VAT increase would therefore be more difficult to implement, which is why the 1992 was chosen as the case study to be examined.

1992 – VAT increase from 10 to 13 per cent. The most important change to the tax system introduced during the Paz Zamora government was the VAT increase from 10 to 13 per cent implemented in February 1992 (*Ley* 1314, 27.2.1992). It should be kept in mind that the reform of 1986 was rather comprehensive and that it was generally considered as having introduced an adequate tax system to Bolivia. Therefore it seems hardly surprising that tax reform was not one of the principal items on the agenda of the Paz Zamora government.

Background: contract change with Argentina.

„We faced the crisis with Argentina, we would stop receiving the income from the gas exports to Argentina so that a financial hole was created and it became necessary to increase the tax." (Maria Felix, Tax Analyst – UDAPE, interview, 30.4.2004)

In January 1992 the *Acuerdo Patriotico* proposed a VAT rise to 13 per cent to Congress. The tax bill was sent together with the general budget proposal. The VAT increase also implied a rise by three points in the complementary tax to the VAT. At the time, Argentina – traditionally one of the principal buyers of Bolivian natural gas – was five months behind in its payments and in May 1992 the contract that had set the terms for this deal between Argentina and Bolivia for the previous twenty years was to run out. The new contract to be set up between the two countries was to lower the price paid by Argentina drastically and losses of around US$150 million were expected (*El Diario*, 25.1.92:2;18.2.92:3). This loss of income represented a significant hole in the Bolivian budget which the government now attempted to fill with the proposed 30 per cent VAT increase which it hoped would raise an additional US$118 million (*El Diario*, 21.2.92:1).

When defending the suggested tax bill to its critics, members of the government almost always pointed to the financial crisis caused by the fall in export earnings necessitating a measure to balance the budget (*El Diario*, various issues). Otherwise, however, the economy showed some positive trends: exports in sectors such as hydrocarbons and mineral and non-traditional exports had increased considerably; the inflation rate was at 14.9 per cent on average between 1989 and 1993 (see Appendix D); and Bolivia managed to obtain various credits from multilateral organisations.

Opposition to the Reform

Private sector. The private sector rejected the tax reform proposed by the government in January 1992 completely. Most outspoken on this issue was the CEPB who persistently criticised the measure via the media and directly in meetings with the government and tried to prevent the VAT increase. The General Secretary of the CEPB, Johnny Nogales, stressed that a tax increase was not an adequate measure to maintain the tendency of economic growth Bolivia currently experienced and to provide an incentive for investment; Carlos Calvo, the President of the organisation, complemented this argument by saying that it would make much more sense to reduce tax evasion and increase the number of taxpayers to make the system more universal rather than expanding the tax burden of those already paying (*El Diario*, 21.1.92:7;22.1.92:1). Another argument the CEPB frequently employed was that the real problem behind the country's financial difficulties was the government's uncontrolled fiscal spending (*El Diario*, 21.2.92:1;22.2.92:1). After meetings with the government and other lobbying activities remained without the desired result of the tax bill's withdrawal, the private entrepreneurs' organisation made a last attempt by carrying out a media campaign against the tax reform: one-page adverts were placed in all of the big national newspapers in which the main argument against the VAT increase was summarised and which called on all Members of Parliament to vote against the executive's proposal.

The Santa Cruz based *Cámara de Industria, Comercio, Servicios y Turismo* (Chamber of Industry, Trade, Services and Tourism, CAINCO) was equally outspoken against the tax increase. Apart from using similar arguments to those of the CEPB they also reasoned that there should be some stability in the tax system and that the Law 843 of 1986 for that matter should not be altered (which seemed a rather lame argument considering that the private sector did not protest when changes where introduced in their favour). CAINCO warned that the measure would deprive the population of its purchasing power which in turn would lead to inflation. They called repeatedly on the government to withdraw the proposed VAT rise and to cut spending instead (*El Diario*, 21.2.92:9;23.1.92:15; 25.1.92:13). Other organisations – such as the *Cámara Boliviana de la Construcción* (Bolivian Chamber of Construction, CABOCO) or the *Asociación Departamental de la Pequeña Industria de La Paz* (Departmental Association of the Small Industry of La Paz, ADEPI) – joined in the protest and the lobby campaign against President Paz Zamora's tax plans (*El Diario* 23.1.92:11;29.1.92:6;3.2.92:3).

COB against VAT rise. While the opposition campaign coming from the private sector was the most organised and forceful, rejection and protest was also prevalent among the workers. While the COB was predominantly concerned with the modest salary rise suggested by the government (which was part of the budget proposal sent together with the tax reform), Bolivia's main trade union also persistently spoke out against the tax bill. The COB brought this issue up during their dialogue meetings with the government and organised mobilisations and protest marches against both the limited salary increase and the tax bill (*El Diario* 22.1.92:7; 29.1.92:1).

Opposition parties in Congress. While both the private sector and the trade unions concurred in their rejection of the government's proposed VAT rise, this negative response was equally voiced by the opposition parties. All three opposition parties – MNR, IU (*Izquierda Unida)*, and CONDEPA – contested the measure. Ernesto Machicado, Member of Parliament for the MNR, the biggest party represented in the legislature, criticised the tax increase in the following way:

"It is a retrograde as it contradicts the fundamental pillar of the tax reform of 1986. The intention then was to charge little so that the people would pay. What the government is doing now is a reversion of this policy and is charging a lot so that in the short term there will be a huge social upheaval and in the medium term people will evade taxes. If taxes are higher there will be more evasion. They are punishing those who are paying taxes which is a very small number of people while what they should rather do is make those pay who do not." (*El Diario*, 21.1.92:3)

In Congress, the MNR presented its own proposal, which mainly suggested to raise the income from the transactions tax instead of implementing a higher VAT rate (*El Diario*, 21.2.92:1). In the days before the vote on the bill in the lower chamber the MNR – as the CEPB had done – carried out a media campaign by putting adverts arguing for the VAT to remain at 10 per cent in the main national newspapers. While their genuine concern about the negative effects of the tax rise should not be questioned, the MNR certainly did not mind that a by-product of this campaign was to position itself for the presidential elections due a year later.[80] All the main opposition parties were thus united in their rejection of the tax reform handed in by the executive, however, their joint votes only added up to 59 out of 130 in total (MNR – 40; CONDEPA – 9; IU – 10).

To summarise the opposition against the VAT rise: the fiercest criticism and extensive lobbying against the bill came from the private sector; in Congress all opposition parties

[80] During the election campaign the presidential candidate, Sánchez de Lozada, promised to lower the VAT rate. When in power, he never fulfilled this promise.

rejected the measure; the COB protested against it; and public opposition from other organised sectors was limited.

VAT increase approved in Congress. In the face of this opposition, the government usually referred to the loss of income from gas exports to Argentina. Cabinet members also pointed out that in the Latin American context the VAT rate of Bolivia was one of the lowest (Blanco, interview, 30.4.2004). Yet to a large extent the executive also simply ignored the critical voices. After the bill had been sent to Congress in January it was discussed as usual in the legislative commission and in the lower house. This process was delayed when in late January some legislators of the *Acuerdo Patriotico* parties themselves brought forward an alternative plan. They suggested to reduce 10,000 jobs in the public administration and including more sectors in the tax regime in exchange for not raising the VAT rate (*El Diario*, 29.1.92:3). After this proposal was made it was not heard of again, however, so that it can be assumed that the dissenting ADN and MIR members were brought back into line by their party leaders. On the 20th of February, the *Acuerdo Patriotico* was reported to have decided that the vote on the bill should be taken the following day. Consequently on the 21st of February the Parliament approved the tax reform (and also the budget) without any modifications with the votes of the ruling parties ADN and MIR. A few days later the Senate also passed the law which was subsequently promulgated by President Paz Zamora (27th of February). The executive had thus implemented its original proposal ignoring the opposition to the measure coming from various sectors. Even after the VAT increase to 13 per cent was approved in the legislature the protests against this measure were maintained: the COB and university students announced a 48 hour strike and further demonstrations against both the salary and the VAT increase. The CAINCO as well as the MNR declared that they would present an appeal of nullity to the Supreme Court (which failed) (*El Diario*, 25.2.92:1,7; 28.2.92:1).

Why the Reform was Possible

The two ministers involved in this piece of tax legislation – Minister of Finance David Blanco and Minister of Planning Samuel Doria Medina – both referred to the opposition they experienced from various sectors and maintained that having the VAT rise introduced was extremely difficult and contentious; Blanco even claimed *"it almost cost me my job"* (Blanco and Doria Medina, interviews, 30.4.+25.5.2004).[81] When asked

[81] In fact, Blanco left his position as Finance Minister soon after the reform went through. The change in this position, however, was part of a larger cabinet reshuffle undertaken by Paz Zamora.

why the reform of 1992 was possible, Bolivia's prominent economist Juan Cariaga pointed out: *"The people accepted the tax regime because ... the memory of the hyperinflation was very strong."* (Interview, Cariaga, 21.5.2004). Responding to the same question, Doria Medina claimed:

"The economic team had a lot of credibility...; it was a moment of economic growth, there was no crisis, so it was not that complicated. Thirdly, I had to travel up and down the country to go and explain; and there was a good control of the Congress." (Doria Medina, interview, 25.5.2004)

Doria Medina mentioned several aspects he considered important to explain why the VAT rise could be introduced. His argument concerning the absence of a crisis and the general period of economic growth was brought forward by various interview sources: Juan Carlos Pereira – the then Director of the Bolivian Internal Revenue Service, Rosa Talavera – tax expert of *PriceWaterhouseCoopers*, and Juan A. Morales – President of the Central Bank since 1996 – all held that the rather positive economic circumstances and outlook made people more willing to pay taxes and to resist the VAT increase less strongly than they would otherwise have done (Pereira; Talavera; Morales, interviews, 28.5.+20.5.+24.5.2004). In the quote above Doria Medina also pointed to the fact that the government had a *"good control of the Congress"*. The tax proposal to increase the VAT from 10 to 13 per cent was a jointly elaborated bill of the two ruling parties ADN and MIR. Apart from the attempt of some members of these parties to have a different tax reform introduced the Members of Parliament of these two parties seemed generally in agreement with the VAT increase or at least willing to vote along party lines. The positive outcome of the attempted reform was hence predictable as the two coalition partners held a majority in the Congress. The existence of the governmental coalition in the form of the *Acuerdo Patriotico* can consequently be considered as a decisive element in explaining why this reform could be introduced especially when taking into account that significant opposition to the measure existed.

Effects. VAT collections rose after the increase of the rate: while they represented 1.93 per cent of GDP in 1993, they rose to 2.31 in 1994 (DGII, 1997:26).

Special Tax Regimes

Another area in which changes to the tax system were made during the government of Paz Zamora were the special tax regimes. These provide small taxpayers of the informal sector with a low tax burden and a simple system (thus freeing them from issuing invoices, tax declarations and the like). The taxes collected under these regimes represent minimal amounts of the total tax income; in 2002 this was 0.1 per cent of all internal tax revenue (Ministry of Finance, 2003). While no official figures exist it is widely held that a large number of businesses with a considerable income hide in these regimes when they should actually pay taxes under the general tax system. To facilitate an overview, the development of these regimes will be summarised below, since the most significant changes to the special regimes have been introduced during the government of Paz Zamora.

From Paz Estenssoro to Paz Zamora. The parallel system to the formal tax regime was set up during the Paz Estenssoro period already: presidential decrees issued in February and May 1987 introduced the "Simplified Tax Regime" (*Régimen Tributario Simplificado*) just a short while after the new tax system decided upon in May 1986 had come into force (*Decreto Supremo* 21521, 13.2.1987; 21612, 28.5.1987). While the formal tax system was based on people and enterprises using tax registry numbers and being able to present invoices for all their transactions, this seemed an unrealistic requirement for small taxpayers and Paz Estenssoro decided to create a simplified system thereby also reacting to pressure coming from the informal sector. Taxpayers of low-income businesses, small retailers or artisans whose earnings were below a specified level formed part of this Simplified Tax Regime. They were classified into four categories and paid a fixed amount of tax instead of paying the tax on companies, the VAT, the Complementary Tax and the Transactions Tax. Taxpayers forming part of the system were not allowed to issue invoices for their goods and services. At the time of its creation in 1986, the simplified regime was planned as a transitory arrangement. The Minister of Tax Collection at that time, Ramiro Cabezas, commented on the idea behind the introduction of the simplified regime:

"Everyone could freely register and every taxpayer said in which category to register. We knew that some who were big would register as if they were small but what we needed to do was to cast a net like a fisherman, so that all would enter the net and once we had them in the net what we needed to do was to check that only the small ones would be in this regime and that the middle and large ones would leave it. Then there was a change of government and the new government did not do this work." (Cabezas, interview, 29.4.2004)

During the time of Paz Zamora's presidency not only did his government not attempt to limit the taxpayers inscribed in the simplified regime, as outlined by Cabezas, he was also widely criticised for having amplified this parallel tax structure. In 1991 Paz Zamora issued a decree to establish another parallel regime called the "Integrated Tax System" (*Sistema Tributario Integrado*) aimed at the transport sector (*Decreto* 23027, 10.1.91). All owners of up to two vehicles used for urban or provincial public transport would be entitled to register and pay a fixed, rather low, amount. The Integrated Tax Regime has been in existence ever since its creation in 1991 and, as a tax analyst of the National Chamber of Industry pointed out, it is widely believed that

"the big transport entrepreneurs are hiding in it, ..., those who have no more than one vehicle do not pass to the general regime so they put the name of their mother, their daughter etc. so that they will not be taken out of the regime." (S. Romero, interview, 28.5.2004)

Other people interviewed confirmed this view that it is common practice in the transport sector to distribute the vehicles owned among the family members so that a higher tax payment in the general system could be avoided (e.g. Villegas, interview, 28.5.2004). Apart from having created another special tax regime which allowed another sector to avoid paying taxes under the general system, the Paz Zamora government also amplified the existing Simplified Tax Regime by introducing a change to the process of registration in 1990 (*Decreto* 22555, 25.7.1990). According to Juan Cariaga:

"Paz Zamora introduced a regulatory decree which was detrimental to the registration and by being detrimental to the registration it became impossible to control the simplified regime ... it was a regulatory decree which distorted the whole concept of the simplified regime... it created a loophole due to which 100,000 people have entered." (Cariaga, interview, 21.5.2004)

The two decrees issued by Paz Zamora in 1990 and 1991 thus represented significant changes to the special tax regimes and allowed more people to avoid taxation under the general regime. While Cariaga gave the number of 100,000, other estimates claimed around 200,000 people had left the general tax regime due to the changes introduced (*El Nuevo Día*, 7.4.2004). Why were these changes to the tax system introduced? Paz Zamora himself described it as a response to the informal sector and considered it as the key to the "social peace" he enjoyed during his presidential period (Paz Zamora, interview, 19.5.2004). The measures were taken in reaction to the pressure the sectors concerned put on the government, particularly from the transport sector which ultimately managed to have its own special regime set up. To this day the *"transportistas"* are a significant political player in Bolivia as they have often used the powerful instrument of threatening a public transport strike to have their demands fulfilled. Though practically all governments (including even the one of Paz Estenssoro which created the special tax regime in the first place) have been subjects to the pressures of the informal sectors, the Paz Zamora government seems to have given in to their demands more than others did. Juan A. Morales (President of the Central Bank since 1996) held the opinion that President Paz Zamora introduced these changes out of *"pure populism"* as the small traders of the informal sector would always represent a large pool of potential voters (Morales, interview, 24.5.2004). Political analyst, Napoleón Pacheco, put the emphasis on the issue of legitimacy instead:

"The government of Paz Zamora yielded easily to the pressures... In the 1989 elections Paz Zamora was the third, but ... he managed to get the votes of the second which was Banzer. So he was legally elected as President, however had no legitimacy before the population which saw that another candidate had won. Therefore the Paz Zamora government, in a search for legitimacy, yielded easily to these pressures and started to distort the tax regime." (Pacheco, interview, 5.5.2004)

Table 4.4: Overview Special Tax Regimes, Bolivia

	Simplified Tax Regime *(Régimen Tributario Simplificado)*	**Integrated Tax System** *(Sistema Tributario Integrado)*	**Unified Regime for Farmers** *(Régimen Agropecuario Unificado)*
Introduced	13.2.1987	10.1.1991	27.12.1996
Legislation	Decree 21521	Decree 23027	Decree 24463
Government	Paz Estenssoro	Paz Zamora	Sánchez de Lozada
Target Group	Small businesses, street vendors, artisans	Transport sector	Farmers

Source: Own elaboration.

During the government of Sánchez de Lozada (1993-97) the special tax regimes were extended further. In December 1996 the "Unified Regime for Farmers" (*Régimen Agropecuario Unificado*) was introduced, aimed at keeping farmers out of the formal tax structure and allowing them to pay a rather low unified tax (*Decreto* 24463, 27.12.1996).

The elimination of these regimes has often been demanded and has been a thorn particularly in the side of the private sector. The CNI, for example, proposed to eliminate the regimes and free low-income groups of the informal sector from tax payments completely (as the costs of administering the amounts paid were higher than the income anyway), and conduct a re-classification so the businesses previously hiding would become part of the general system (Vidaurre, interview, 28.5.2004). This proposal was in its essence taken up by President Mesa, who attempted to abolish the special regimes. In early April 2004, the finance minister explained that the elimination would mean that people of low income would no longer pay any contribution; at the same time the reform would entail a re-categorisation aimed at discovering the large evaders hiding in the system (*El Nuevo Día*, 7.4.2004). After this announcement massive protests and marches occurred and in the end, the government of Mesa gave in to the pressures, withdrew the plan, and declared that all special tax regimes would be maintained (*El Nuevo Día*, 22.4.2004). In fact, in a way President Mesa again amplified the special tax regimes. In a decree issued in May (*Decreto* 29494, 14.5.2004) the amounts applying to the Simplified Tax Regime were readjusted: while so far everyone earning up to BOB18,800 qualified to register for the simplified tax system (*Decreto* 24484, 29.1.1997), Mesa raised the amount to BOB27,736, thus making more people eligible than previously.[82] According to Alberto Machicado, Vice-minister of Tax Politics[83] between 1997 and 2002, this change would distort the system even more (Machicado, interview, 25.5.2004). At the same time, however, the Mesa government carried out a large-scale re-categorisation process that had been initiated during the Sánchez de Lozada period in which taxpayers had to re-register, aimed at reducing tax evasion and discovering those businesses falsely inscribed in the special tax regimes.

The special tax regimes were all established and subsequently modified by decree, and were therefore at the complete discretion of the president. Given that the Bolivian Constitution only provides presidents with the ability to issue regulatory decrees and does not give them the power to introduce new legislation, the legality of these special regimes has sometimes been questioned. Tax lawyer Alvaro Villegas defined these regimes as "unconstitutional" and pointed also to the fact that in terms of legal procedure they could easily be abolished (Villegas, interview, 28.5.2004). A simple decree would suffice to abolish this parallel structure; however, this has proved to be politically impossible ever since the Simplified Tax Regime was introduced in 1986 as a "transitory measure". The existence of these regimes indicates a limit of the institutional approach: pressure of popular sectors brought the special tax regimes into existence and prevented presidents from abolishing them – though they would have had the institutional means to do so. However, this example also shows how the private sector lacked influence on tax measures.[84]

[82] Those earning BOB5,001-27,736 are classified into six categories, the charges being: BOB16, 66, 146, 218, 518, 646 respectively, paid every two months. Those earning less than BOB5,001 are exempt (*Decreto* 29494, 14.5.2004).

[83] Vice-ministers to the Minister of Finance are appointed to oversee different areas; one of them is Tax Politics.

[84] In Ecuador no special tax regimes exist, the informal sector does not pay taxes. A few years ago an attempt was made to introduce a simplified tax regime in order to amplify the number of taxpayers and include the informal sector. The reform was rejected in Congress, however.

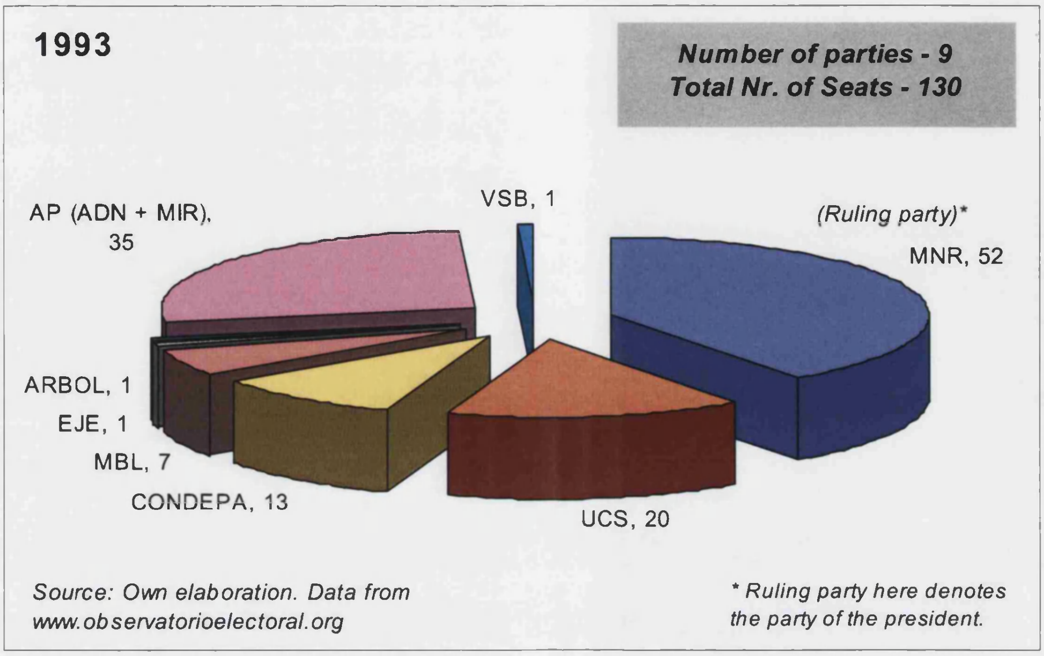
4.4 The Government of Sánchez de Lozada (1993-1997)

1993 elections. In 1993 Gonzalo Sánchez de Lozada won a plurality in the presidential elections for the second time after he had already received the highest number of votes in the 1989 elections. Sánchez de Lozada (MNR) gained 35.6 per cent and thus defeated Hugo Banzer (21.1 per cent, ADN) with a clear margin in the first round. This was the only presidential election since 1985 in which a candidate received more than 30 per cent of the votes in the first round. The MIR had not presented a presidential candidate as they had remained loyal and presented itself with the ADN as the *Acuerdo Patriotico* in the elections. The two populist parties CONDEPA and UCS were the third and fourth placed candidates, having gained 14.3 per cent and 13.8 per cent of the votes respectively (CNE, 2005a). While CONDEPA had already participated in the 1989 elections, UCS was a new party to the political scene. The UCS was founded by Max Fernández, owner of the country's largest beer brewery. It had its support base mainly among the urban poor and received votes from throughout the country (in contrast to CONDEPA which is mainly La Paz and El Alto based).

Finding coalition partners. While Banzer and the *Acuerdo Patriotico* did not accept the victory of their opponent Sánchez de Lozada for a while, the MNR managed to negotiate the support of the MBL, a small leftist party, in early June, which later developed into a governmental coalition – termed *Pacto por el Cambio* (Pact for Change). This first deal sent a signal, and shortly afterwards Banzer admitted his defeat by congratulating Sánchez de Lozada and by announcing that the *Acuerdo Patriotico* members would vote for him in the elections of the second round in Congress. A few weeks later, another coalition partner was found in the UCS with whom the MNR formed the *Pacto por la Gobernabilidad* (Governability Pact). What was new about the situation in 1993 was that the ruling MNR was not dependent on forming a coalition with the second or third-biggest party in Congress since they held such a large number of seats. The room for manoeuvre was hence much bigger in Sánchez de Lozada's case. It was also the first coalition that consisted of three political parties rather than two. Together with the UCS and the MBL President Sánchez de Lozada was able to count on the support of 79 out of 130 Members of Parliament: 52 of his own MNR, 20 of the UCS, and 7 of the MBL.[85]

[85] Apparently also the members of CONDEPA voted in favour of the main laws proposed by the government (Ballivian, 1999:42).

Figure 4.5: Composition of Lower Chamber 1993, Bolivia



To facilitate the formation of these coalitions, however, the political allies demanded their share of government positions. The UCS received the Ministry of Defence, two undersecretary positions, two ambassador posts, the presidency of one regional development corporation and the first vice-presidency of both the Chamber of Deputies and the Senate. The MBL in turn was able to negotiate the Ministry of Foreign Affairs, some key congressional posts, and at least one embassy (Gamarra and Malloy, 1995:423-24).

Economic reforms. In his election platform Sánchez de Lozada announced his policy proposals as a *"Plan de Todos"*: promising a "social market economy" it aimed at providing economic stability, improving health and education, promoting citizen participation, facilitating investment, reducing corruption, and creating jobs (Gamarra, 1997:385). He also promised to lower taxes. Once in power, Sánchez de Lozada (with the help of the votes of the coalition members) introduced several wide-ranging economic policies during its administration between 1993 and 1997, principally in the areas of privatisation, education and decentralisation. A series of "second-generation" reforms was undertaken; the Capitalisation Law, Popular Participation Law, and Education Reform Law, all introduced during the first year of the Sánchez de Lozada government.[86] While the reforms introduced mirror his election campaign to a large

[86] For more information on the capitalisation process see Chapter 3.7.

extent, the "social" market model took a back seat: though he had promised to alleviate social costs, he introduced austerity measures particularly during the first two years of the government in order to prevent an economic crisis (Gamarra, 1997:387). As will be seen later on, Sánchez de Lozada also did not keep his promise to lower taxes.

Instability of coalition. That these reforms were introduced during the first year of his government was probably to the advantage of Sánchez de Lozada as governing and keeping the coalition together became more and more difficult over time. The UCS proved to be rather unreliable: their leader Max Fernández repeatedly complained about being left out of the decision-making process by Sánchez de Lozada and there were frequent rumours that the UCS was about to leave the government. They ultimately did leave the coalition in December 1994. However, within months they decided to rejoin and were back in the coalition in mid-1995. In late 1995 UCS leader Fernández died in a plane crash, which left the party severely weakened and a rather inactive coalition partner for the rest of the legislative period. Apart from these inter-party difficulties the President was also facing some intra-party problems. A conflict evolved between the members of the MNR and the cabinet (to which Sánchez de Lozada had appointed mainly technocrats rather than long-term party members). At that time a joke among the Bolivian political class said that *"Sánchez de Lozada forgot that to govern Bolivia one must always sign a pact with the MNR."* (Gamarra, 1997:386). By March 1994 the discontent among the MNR partisans had reached such proportions that the MNR leader gave in to the pressures and restructured the cabinet replacing many of the private sector people by party loyalists.[87] Sánchez de Lozada thus had to change his strategy and make relations with the MNR party members more of a priority in order to secure support for his economic policy proposals. This pattern supports the thesis brought forward by Javier Corrales who argued that a harmonious relationship between the executive and the ruling party is necessary for the introduction of deep economic transformation (Corrales, 2002).

Social conflicts. The government was confronted with various strikes and protests during its four years in power. The COB organised various marches and university students and teaching unions demonstrated particularly against the education reform. Gamarra argued that this resurge in the degree of social conflict (after a relative low during the Paz Zamora period) can be accounted for by the relative fragility of the

[87] Another major cabinet reshuffle took place in September 1995.

ruling coalition on the one hand, and the increasing frustration of the Bolivian population with the results (or lack thereof) of the austerity measures and economic policies undertaken since 1985 (Gamarra, 1997:389).

Tax Reforms during the Sánchez de Lozada Government

As of mid-November 1994, the Sánchez de Lozada government started to circulate a proposal regarding the budget for the upcoming year, part of which entailed new tax legislation. The executive finalised the project by late November when it was sent to the Congress for discussion. The main changes planned for the tax system were:

a) replacing the 2% Tax on the Presumed Profits by a Corporate Income Tax of 30%;

b) raising the rate of the Transactions Tax from 2% to 3%;

c) modifying the Special Consumption Tax (new tax on sale of vehicles of 20%; alcohol and soft drinks now levied a fixed amount per unit instead of a percentage);

d) modifying Property Tax: a) rates for real estate lowered at top end; b) rates for vehicles increased.

Corporate Income Tax to replace tax on presumed profits. The 1986 reform had abolished the Corporate Income Tax and had put a Tax on Presumed Profits in its place given that it was easier to administer. Generally, however, this form of taxation was considered to have many disadvantages so that the possibility of re-introducing a Corporate Income Tax had been discussed for some time also within the private sector. Ramiro Cabezas, one of the protagonists of the 1986 reform and hence responsible for the Tax on Presumed Profits of Companies, explained why the tax was introduced in the first place and what disadvantages it turned out to have:

"For simplicity we applied a Tax on the Presumed Profits of Corporations, which made it very easy to calculate the tax, made it very easy for the taxpayer to make their payments. However, it had the disadvantage that the companies which made losses had to pay the tax on the presumed profits anyway. And it had the other disadvantage that some companies with capital from abroad could not deduct the tax on presumed profits in their country of origin." (Cabezas, interview, 29.4.2004)

Cabezas pointed to the negative effects of the tax created in 1986 on the companies within Bolivia as well as foreign enterprises investing in the country. As regards the companies within Bolivia, the Tax on Presumed Profits was widely considered to be distortionary as companies who probably had valuable assets would not necessarily generate high incomes, while a company with few assets, on the contrary, might produce high profits (Antelo, interview, 24.5.2004). In extreme cases a company might make losses and still would need to pay the Tax on Presumed Profits and thereby further reduce its potential for productivity. Juan Antonio Morales, President of the Central Bank since 1996, summarised the shortcomings of this tax:

The Tax on Presumed Profits *"had a very defective design ... The businessmen considered it* (the Corporate Income Tax, SL) *as being better because the previous tax was a tax on the assets of the companies, on their machines, their buildings and they said very often that the company was not producing and on top of it we have to pay this tax. The tax on profits, on the other hand, was a tax on something that was principally verifiable."* (Morales, interview, 24.5.2004)

In consequence of this, the private sector mainly welcomed the initiative of the government to introduce a tax on enterprise profits, as some parts of this sector had lobbied for this change for a while. Gerardo Velasco of the CNI pointed out that they had pushed for this change to happen as well (Velasco, interview, 27.5.2004). While this was one motivation for the government to introduce the change, the aspect regarding foreign companies, as mentioned by Cabezas above, was at least as important as the argument concerning the distortions created for Bolivian companies. At the time of this tax reform Bolivia was undertaking to privatise its state companies and earlier in the same year, in February 1994, a "Capitalisation Law" had been approved in Congress giving the legal framework for this endeavour. The Tax on Presumed Profits was a tax that foreign companies could not deduct from their tax payments back home, which, however, would be possible with a corporation tax. Given this situation changes to the tax system became necessary to facilitate the capitalisation process, as commented upon by Carlos Otálora, Director of the Internal Revenue Service later on during the Sánchez de Lozada government (1996-97), who said that *"in order to capitalise, Bolivia had to change the system"* (Otálora, interview, 12.5.2004).

In summary, there were two main reasons why the government decided to introduce a Corporate Income Tax in 1994: on the one hand to eliminate distortions created by the previous Tax on Presumed Profits and to introduce a more just tax; and secondly as the tax was not deductible abroad and therefore presented an obstacle to foreign investment the government was keen to attract at this moment when the capitalisation process began. Another aspect that most probably was part of the government's deliberations as well – though not part of the public discourse – was that the collections of the Tax on Presumed Profits were extremely low. As Juan Cariaga, who was involved in establishing this tax, said *"the Tax on the Presumed Profits of Companies did not collect anything, everyone got indebted and no one paid taxes"* (Cariaga, interview, 21.5.2004). According to data of the Internal Revenue Service, the income generated from the Tax on Presumed Profits represented merely 0.42 per cent of GDP on average between 1987 and 1994 per year (DGII, 1997:26).

Apart from the corporation tax, some other changes to the tax system formed part of the proposal: the Transactions Tax introduced by Law 843 in 1986 at a rate of 1 per cent and raised to 2 per cent in 1990, was now proposed to be increased to 3 per cent. This tax was generally strongly contested by the private sector for its cascade effect. As regards the changes to the excise tax the most important element was the proposed introduction of a 20 per cent tax on the sale of vehicles. Some of the excise taxes were also to be restructured: the levy on alcohol was unified, and several products were now charged a fixed amount instead of a percentage (for example, alcohol such as beer and wine, soft drinks).[88] The rates of Property Tax on real estate were lowered at the top end (e.g. the owner of real estate worth BOB400,000 now had to pay an annual tax of BOB1,700 instead of BOB2,880). The tax levied on vehicles (cars, motorboats, airplanes), however, was increased, ranging from 1.5-5 per cent (previously 0.5-4 per cent). Excise tax for jewellery and electrical appliances was abolished.

President Sánchez de Lozada explained the measures declaring that they represented a restructuring of the tax system, the effect of which would be neutral and would not affect living costs. As regards the Corporate Income Tax, its introduction had become necessary due to the capitalisation process and would benefit the business sector. Several times he defended the measure as a means of avoiding the implementation of a fuel price hike (an argument he also used to threaten the opposition) and criticised the opponents of the reform as he considered the demonisation of the reform unfair (*El Diario*, 23.11.94:1;22.12.94:1). Even before the proposal was submitted officially – but more forcefully after that – opposition came from political parties, trade unions, local governments, and particularly from the private sector.

Opposition to the Reform

Private sector. When the government's plans were first made known, the Bolivian Private Entrepreneurs' Federation (CEPB) immediately started setting up what was to become a rather massive campaign against the proposed tax legislation. While they generally agreed to replacing the Tax on Presumed Profits with a Corporate Income Tax, they strongly criticised the rate of 30 per cent proposed by the government and

[88] The rates were: Beer, wine, spirits – BOB1.20; Soft Drinks – BOB0.15 (rates to be adjusted annually depending on the exchange rate to the dollar). *Ley* 1606, 22.12.1994.

suggested a rate of 20 per cent instead. The other element of major concern to the private sector was to maintain the Transactions Tax at its current 2 per cent. Carlos Chazal, President of the CEPB, summarised their position:

"We are against any tax increase, be it the VAT, the Transactions Tax, among others. Because of this we have come to fight and to show that the corporation tax should never be higher than 20 per cent as it would deprive the national private sector of competitiveness." (*El Diario*, 19.11.94:9)

Other arguments used by this private sector organisation were: that the measure had a recessionary effect on the economy (*El Diario*, 20.11.94:1;17.11.94:11); that the possibilities for development would be diminished by the reform (*El Diario*, 10.12.94:5); that other countries would not have such high rates as 30 per cent in their Corporate Income Tax (*El Diario*, 17.11.94:11); that Bolivia would lose out against other countries when implementing this tax regime and lose its competitiveness to attract investment in this period when countries of the developing world were opening their economies (*El Diario*, 15.12.94:1). As an alternative to the measures announced by the government, the CEPB proposed to amplify the universe of taxpayers (*El Diario*, 21.11.94:4). In late November the CEPB decided to declare a state of emergency for all private entrepreneurs of the country and convened an extraordinary Congress (*El Diario*, 24.11.94:1;1.12.94:1). While declaring a state of emergency might not have many practical consequences it had a symbolic meaning and showed the determination of the CEPB to prevent the changes to the tax system. Holding an extraordinary Congress confirmed this as it is not a measure the entrepreneurs' federation has often resorted to. To lobby against the reform proposal the CEPB spread their criticism widely and not only entered into direct discussions with the executive but also convened meetings with the leaders of the different parties represented in Congress, with Members of Parliament and senators, and with the economic commissions of both chambers. In addition to these meetings, a position paper was formulated and distributed widely. Apart from attempting to win over the institutional arena of Bolivian politics, the private sector also carried out a well organised campaign in the public sphere. A series of advertisements criticising the tax bill was placed in the country's largest newspapers and articles summarising the points of view of the CEPB repeatedly made the headlines and could be found on the first page of the papers (*El Diario*, 20.11.94:13; 2.12.94:1).

Other private sector organisations joined forces with the CEPB and spoke out against the planned tax increases of the government. The CNI criticised the proposal of a 3 per cent Transactions Tax and a 30 per cent (or later 25 per cent) corporate tax and reminded the government that they had in fact promised to lower taxes in their election campaign, therefore the least they should do would be to maintain the current rates (*El Diario*, 17.11.94:8). According to the *Cámara Nacional de Comercio* (National Chamber of Commerce, CNC) the 1 per cent rise in the Transactions Tax would trigger a considerable rise in living costs and would represent an attack on the country's productivity and competitivity. Furthermore, the measures would increase informality and smuggling (*El Diario*, 19.11.94:15). The *Federación Boliviana de la Pequeña Industria* (Bolivian Federation of the Small Industry, FEBOPI) went as far as threatening to stop paying their taxes should the legislation get through; they proposed a series of alternative measures instead, all of which were aimed at reducing the tax burden of their sector (*El Diario*, 26.11.94:9;12.12.94:4).

In early December the government of Sánchez de Lozada agreed to enter into negotiations with the private sector as represented by the CEPB: after a series of meetings the executive did not give in to the demands of the private sector for a 20 per cent Corporate Income Tax, though, however, did agree to lower the proposed rate to 25 per cent. Another minor concession was made in excluding fruit juices from the excise tax which had been claimed by the corresponding sector (*El Diario*, 20.12.94:8); the rates established for wine and beer also formed part of the negotiations but were maintained by the government. The increase to a 3 per cent Transactions Tax – though heavily contested by the business lobby – remained unmodified (*El Diario*, 10.12.94:5). While the government claimed that the modifications made represented a consensus reached with the private sector organisation, the CEPB declared that no agreement existed and that their concerns had not been heard (*El Diario,* 17.12.94:12). They thus remained opposed also to the new version of the bill. The CEPB continued to criticise particularly the 3 per cent tax on transactions and the 25 per cent for the Corporate Income Tax which they considered as being too high. When assessed in a comparative perspective this claim seems questionable, however, as in many other Latin American countries rates were higher than 25 per cent. Top rates of the tax on corporations averaged 38.1 per cent in Latin America in 1991 and 34.2 per cent in 1997 (Shome, 1999:5).[89]

[89] Data was provided for 18 countries from South America, Central America and the Caribbean; it was unavailable for other years. Note that the comparison has its limits given that a flat rate is compared with top rates.

Political parties. Opposition to the project came also from the majority of the parties outside the ruling coalition, most strongly among them the ADN but also CONDEPA and former coalition partner UCS. The UCS had left the ruling coalition in the month the tax reform was presented (a few of its members nevertheless continued to vote with the government). The opposition parties accused the government of using an easy way to balance the fiscal deficit and criticised the planned changes regarding transactions and corporation tax using arguments similar to those of the CEPB. They also pointed out that the current economic situation was not actually that good and that raising taxes would not be the appropriate measure at the moment (*El Diario*, 22.11.94:3,7). After the new legislation passed Congress several of the parties that had been opposed – ADN, MIR and CONDEPA – handed in an appeal of unconstitutionality to the Supreme Court (which was not approved, however).

COB and municipal governments. After the proposed tax legislation was made known, rejection also evolved within the trade union and popular sectors. Bolivia's main trade union, the COB, criticised the reform measures and reproached President Sánchez de Lozada for not keeping his election campaign promise to lower the VAT rate to 10 per cent and considered the bill an *"attack against the interests of the country's municipalities"* (*El Diario,* 21.12.94:7). They announced protest marches and a national strike, most of which, however, were only carried out after the reform had already been approved and then had little effect (*El Diario*, 25.11.94:11;20.12.94:4;30.12.94:5; 28.1.95:5). Other organisations equally condemned the government's plans as did, for example, the transport sector and the National Federation of Mining Cooperatives (*El Diario*, 3.12.94:5;19.12.94:5). In Santa Cruz a joint meeting of the trade union movement, private entrepreneurs, the universities, representatives of the agricultural sector, and the legislators of Santa Cruz was organised to analyse the tax bill. This rather unusual co-ordination of diverse groups resulted in a joint document that criticised the executive's plans (*El Diario*, 3.12.94:11). While opposition was thus voiced from the trade unions and other sectors it was not as forceful in 1994 as their reactions to other cases of tax reform. This can be explained by the fact that part of the reform did not affect these sectors (as was the case with the newly introduced corporation tax); or in the case of the 1 per cent increase of the Transactions Tax, its effects were not as easily understood as, for example, a VAT increase would have been (even though an increase in this tax ultimately increases consumer prices in a similar way).

The strongest opposition to the reform, apart from the private sector, came from the municipal governments. The issue of contention was the provisions made regarding the Special Consumption Tax and the Property Tax: the municipal governments pointed out that the project would have all income from the excise taxes go to the national Treasury while previously the municipalities had received a share via the system of "co-participation" (*coparticipación*), which entitled them to 20 per cent of all revenue of national taxes, according to the new Popular Participation Law of 1994 (*Ley* 1551, 20.4.94). The municipalities protested that the tax on real estate and vehicles were lowered and opposed this as they received a share of these taxes so their income would be reduced (*El Diario*, 17.12.94:6). While it was true that the rates for real estate were lowered at the top end, the charge levied on vehicles was actually increased (see section on the elements of the tax reform above). The municipalities thus feared a decrease in their income and their representative body – the Association of Municipal Governments – consequently campaigned heavily to prevent the proposed changes (*El Diario*, 15.12.94:15;17.12.94:6; 30.12.94:6). The universities joined in this protest and declared a state of emergency to show their opposition as they alleged that: *"The tax reform eliminated the tax destined for the universities and notably reduced the municipal governments' dominance over taxes."* (*El Diario*, 21.12.94:7)

The opposition of the municipal governments, however, was apparently based on a misinterpretation of the tax bill: in fact, the "co-participation" principle was not at all affected by it and would also continue to apply to the excise taxes. While the municipalities assumed that their income was to be reduced they were actually to receive more money in consequence of this reform. Surprisingly, however, the government did not publicly clarify this issue while the discussion was going on and simply ignored the criticism of the municipal governments. Only after the bill was approved in Congress, cabinet members made public statements on this issue. President Sánchez de Lozada was the first to point out that the municipal governments and universities would receive significantly more money than before (*El Diario* 22.12.94:4); a statement that was elaborated further when Gaby Candía, the National Secretary of Finance, gave a press conference a day after the reform had passed Congress:

"The municipalities' and universities' income will not be reduced, therefore it is not an attack as is manifested, rather with the reforms to the law a considerable increase of their incomes will be produced, because the co-participation of the VAT and the excise tax is maintained." (*El Diario*, 23.12.94:8)

The Ministry of Finance declared that the protests were due to ignorance of the law and therefore unjustified. This correction of the widespread misinterpretation of the new tax legislation was later backed by figures published by the government: the reform would cause an increase of around 10 per cent in transfers to the municipal governments (*El Diario*, 13.1.95:8;29.12.94:11). This clarification revealed that the opposition of the municipalities had indeed been based on false assumptions. In a meeting held by the Association of Municipal Governments of Bolivia it was decided that they would call off all protest measures and accept the changes introduced to the tax system as they realised that their budgets were actually not affected and would even benefit in some regions (*El Diario*, 12.1.95:6).

1994 reform approved in Congress

In mid-December, after the executive made some changes to the tax reform due to the negotiations with the private sector, the discussion of the bill in Congress was speeded up by the ruling coalition. Since the new tax legislation was supposed to come into force by the beginning of the fiscal year starting on 1 January, 2005, the government had some urgency to have it approved before the end of the year. In the session taking place a few days before Christmas, the members of the opposition parties were absent as they wanted to symbolise their discontent with the fact that the government had not consulted them and the wider society about the proposed reform at all (*El Diario*, 23.12.94:1). The reform was then approved without any modifications with the votes of the MNR, MBL, and MPP (*Movimiento Popular Patriótico*, a group that split up from the CONDEPA and joined a coalition with the MNR) which formed the ruling coalition, and also the votes of some dissidents of the UCS. Two days later the tax reform was confirmed also by the Senate and subsequently promulgated by President Sánchez de Lozada.

The legality of the new legislation was questioned by the opposition parties for two reasons. Firstly, the session convened by the President of the lower chamber, Javier Campero Paz, on the 20th of December was considered to be unconstitutional. The leaders of the opposition parties – ADN, MIR, UCS, CONDEPA, VSB (*Vanguardia Socialista Boliviana*), EJE Pachakutik – pointed out that the Parliament had just a few days earlier decided upon the congressional recess to start on the 19th of December (*El Diario*, 20.12.94:3). According to their view, Paz Campero had ignored this decision and by assembling the Parliament had violated legislative procedures. The other argument used by the opposition was the apparent lack of a quorum during the session. Given the 130 seats in the Bolivian Parliament a quorum is reached with 66 of its members present. Several reports of the session stated, however, that no quorum had existed at several times during the discussion (*El Diario*, 21.12.94:1+3). Since the opposition was not present during the session, no one asked to have the quorum verified and the session continued without interruptions. A few days after the discussion in the Parliament it was reported that the official record of the session had registered 65 legislators to be present. According to *El Diario* the Secretary of the Lower Chamber then proposed to change this number to 68 (which would represent a quorum) and President Campero Paz approved of this change and signed the document to "legalise" the tax reform (*El Diario*, 23.12.94:3). In the aftermath of the decision the opposition parties presented a directive of nullity to the lower chamber's President, arguing that the procedure surrounding the tax reform had been unconstitutional given the decision of the recess and the lack of a quorum. Javier Campero Paz, however, rejected the appeal (*El Diario*, 22.12.94:4; 23.12.94:3).

Table 4.6: Tax Reform of 1994 – Original Proposal and Approved Legislation

	Original Proposal	**Approved**
Corporate Income Tax	**30%**	**25%**
Transactions Tax	3% (previously 2%)	
Excise Tax	a) **20%** tax on sale of vehicles; b) fixed amount for alcohol + soft drinks	a) **18%** (vehicles) b) fruit juices exempt
Property Tax	a) 0.35% - 1.5% on property (from 0.15%-2.65); b) 1.5% - 5% on vehicles (from 0.5%-4%).	

Source: Own elaboration.

Summary. The reform approved in December 1994 represented the second most important piece of tax legislation (after the 1986 reform) introduced during the last two decades. At its centre was the introduction of a Corporate Income Tax, other important elements included an increase in the Transactions Tax, and changes to the excise and property taxes.

While the great bulk of the proposed legislation was approved as proposed by the executive some modifications were introduced in the course of the discussions. President Sánchez de Lozada was facing a period of instability in his ruling coalition, as its main coalition partner UCS left the very month the tax reform was being discussed; other coalition partners such as the MPP lost some members during that period. The coalition was thus fragile and it was not always certain if the MNR would reach a majority of votes in the Congress to approve the bill, as was reported by *El Diario* in early December: *"Majority of MNR in the Parliament in Danger"* (4.12.94:4). The pressure to modify the proposed reform came mainly from private sector groups in response to which the government made some concessions; most significantly the Corporation Income Tax rate was lowered to 25 per cent. Demands by the business groups for an even lower rate and other changes were ignored by the Sánchez de Lozada government, however. In Congress – where votes came from the MNR, its coalition partner MBL and some other smaller parties – the bill was approved without any further modifications. The government was in the fortunate position that the ruling party itself already held 52 seats in the Parliament, adding up to 59 together with the MBL, which already came close to a majority in the 130 seat strong legislature. Despite this favourable position some extra-institutional manoeuvring was apparently necessary for introducing this reform as it seems that no quorum was reached in the session where the tax bill was approved.

Effects. In terms of economic outcomes the reform can be evaluated as rather positive. Tax collections of the Transactions Tax rose from 1.6 per cent of GDP in 1994 to 2.1 per cent in 1995; the new Corporate Income Tax resulted in revenues of 1.4 per cent of GDP in 1996 while the previous Tax on Presumed Profits had collected 0.6 per cent of GDP at its best throughout its existence (DGII, 1997:26).

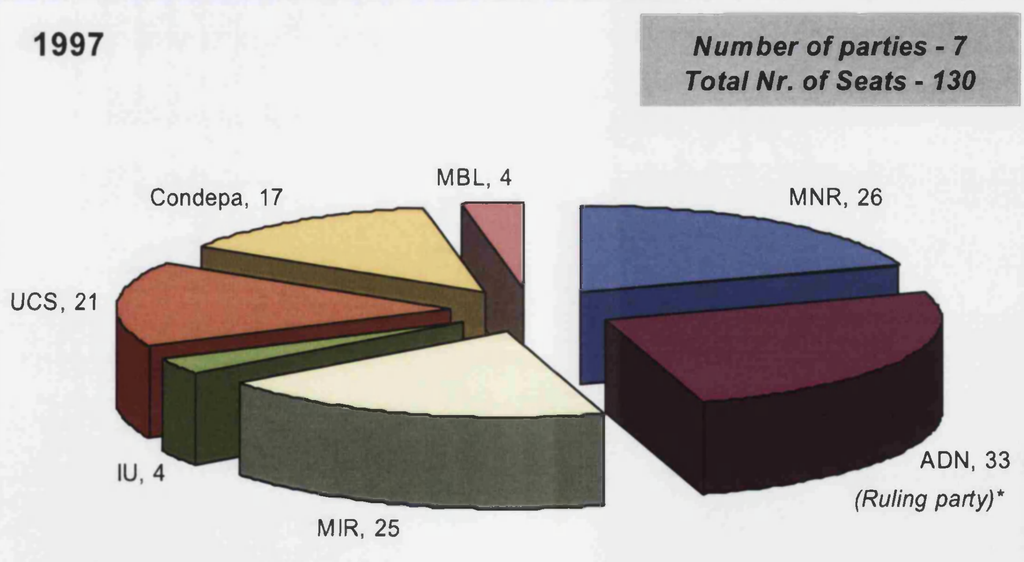
Conclusion. In all cases considered in this chapter – 1986, 1990, 1992 and 1994 – tax reforms could be introduced due to the existence of a ruling coalition providing presidents with sufficient partisan support in Congress. In 1986, hyperinflation was an additional crucial factor which made Bolivians accept the introduction of a wide-ranging economic reform. The memory of hyperinflation still seems to have played a role in the introduction of the 1992 reform. Business groups had little influence on the three tax reforms: hardly any concessions were made in 1986; in 1992 the private sector opposed the tax changes heavily but the government went ahead without any compromises; only in 1994 did interest groups manage to achieve some changes yet still remained unsatisfied with the modified version. Protests against the tax reforms by trade unions and other popular sectors, particularly the COB, occurred in all cases. In 1986, however, their protest potential was weakened, as Paz Estenssoro made use of his emergency powers to this end. In 1992 the COB protested against the VAT rise but was mainly concerned with achieving a higher salary increase; in 1994 protest from trade unions and popular sectors was limited as the tax changes were not that visible and largely affected the private sector. In none of these cases did the protest of trade unions and other sectors make any difference to the tax reforms ultimately introduced. No evidence was found that external actors played a significant role in any of these cases. In 1986, for example, there was some external pressure to lower the fiscal deficit, yet no specific proposals were made and neither the World Bank nor the IMF were particularly supportive of the tax reform at first.

5 Bolivia: The Decline and Eventual Breakdown of Coalition Politics – Tax Reforms during the Governments of Banzer, Sánchez de Lozada and Mesa (1997-2004)

5.1 The Government of Banzer and Quiroga (1997-2002)

In the elections of 1997 Hugo Banzer presented himself as presidential candidate for the fifth time since Bolivia's return to democracy and for a second time won a plurality of the votes (which he had had already in 1985 but then did not get elected in the second round). Banzer and his ADN won 22.3 per cent, followed by the MNR with 18.2 per cent, the MIR with 16.8 per cent, the UCS with 16.1 per cent and CONDEPA with 17.2 per cent (CNE, 2002a). The noteworthy pattern of this election was that five parties all received between 16 and 22 per cent of the votes thus giving them relatively equal power within Congress. UCS and CONDEPA, which had been quite strong already in the previous election of 1993, maintained and extended their important position within the Bolivian Congress. At the same time the 1997 election confirmed the declining trend the traditional political parties were experiencing as the MNR, ADN and MIR together received fewer votes than they previously had.

Figure 5.1: Composition of Lower Chamber 1997, Bolivia



Source: Own elaboration. Data from www.observatorioelectoral.org

** Ruling party here denotes the party of the president.*

"Mega-coalition". Following the first round of the election Banzer's ADN managed to reach agreements with the MIR (its coalition partner of the 1989-93 period), the UCS and CONDEPA. With their support the former military dictator Banzer was elected President by the Bolivian Congress on 6 August, 1997. The coalition partners supporting his election became a governmental coalition and posts were shared between them. What was unusual about Banzer's approach to coalition-building was that he did not cease to find partners when a majority was ensured but carried on to integrate as many parties as possible. Ultimately, four out of the five main parties represented in Congress formed part of the ruling coalition, practically leaving the MNR as the only opposition party (together with the smaller MBL and IU). Together these parties held 96 out of the 130 seats in the Chamber of Deputies and 24 out of 27 seats in the Senate. The coalition can therefore be truly termed a "mega-coalition". When asked why Banzer chose to involve such a heterogeneous group of parties, Salvador Romero Ballivian of the National Electoral Court maintained:

"Banzer was – in quotation marks – an innovator in this perspective because he put together an immense coalition that can be explained not because he wanted to have a great majority in the Parliament but because he had been a dictatorial leader in the 70s. By forming this enormous coalition he wanted to say 'look, now I am a democrat and I have been elected with more than 80 per cent of the Parliament's votes in a democratic manner' ... there was this psychological dimension, which actually had nothing to do with politics." (Ballivian, interview, 28.4.2004)

While President Banzer's motivation can perhaps be explained by his desire to enter history in a certain way, on the political level the coalition constructed by him turned out to be rather difficult to manage. As could have been expected, it was difficult to come up with a coherent programme and there was a high level of in-fighting almost from the start. As a result, CONDEPA was the first party to leave in August 1998, a year after the coalition had come into existence. This was not a major loss since the ruling coalition still held a comfortable majority. The situation became slightly more precarious when the NFR was expelled from the coalition in February 2000 for the following reason. The leader of the NFR, Manfred Reyes Villa, was the Mayor of Cochabamba where in January 2000 a popular uprising forced the government to re-nationalise the city's water supply system which had been privatised only months earlier (see also Chapter 3.7). Prior to the conflict, a committee sent by the executive went to Cochabamba to negotiate a 20 per cent rise in the water rates; the Mayor Reyes Villa, however, boycotted the measure. This led to the ousting of the NFR from the government coalition as President Banzer accused Reyes Villa of a lack of loyalty to the government.[90] The NFR had formed an electoral coalition with Banzer; on their exclusion from the coalition the eleven NFR Members of Parliament became a separate parliamentary group.

According to the Economist Intelligence Unit (EIU) the ruling coalition was left with only 64 seats in Parliament in April 2000, down to 62 by July of the same year (EIU, 2000:9; July 2000:4). While this was technically not a majority any longer (the Chamber of Deputies has 130 seats), the government was still generally able to gather sufficient votes as seven CONDEPA legislators continued to support the government after their party had left the coalition (EIU, April 2000:12). In addition, given the lack of coordination among the opposition parties and the frequent absence of many legislators in parliamentary discussions 64 or 62 votes of the ADN – MIR – UCS coalition most probably represented a de facto majority. However, even though the coalition was down to a more manageable number of three parties, in-fighting between them continued, especially when the presidential elections of 2002 drew nearer. On 23 March, 2001, the Congress was temporarily closed due to a conflict between the parties of the ruling coalition (EIU, April 2001:12). During the presidential period of General Banzer the initially formed "mega-coalition" thus went through a process of gradual dismantling. Edgar Millares, who was the Minister of Finance during the first year of Banzer's presidency, commented on this process:

"The first split in the coalition happened during the first year when they have to get rid of CONDEPA and by and by they had to do away with the other parties because there was no objective for the future, I believe, and the government's programme that was put together was rather incidental." (Millares, interview, 29.4.2004)

Reforms during Banzer's government. Banzer's election campaign had been rather vague and did not entail any specific economic policy programme. He did, however, promise to fight poverty and to improve social services that had been neglected during the previous years, which appealed to large parts of the electorate. His conservative ideology based on the concepts of order, stability, work and family also seems to have attracted voters from a conservative farmer background as well the urban middle class. He also used sought to boost his election campaign by criticising the reforms introduced by Sánchez de Lozada, particularly the capitalisation law. Prior to the elections Banzer as well the leaders of the MIR and CONDEPA had signed a public document

[90] According to the ADN until that time an agreement existed to nominate Reyes Villa as joint presidential candidate of ADN and NFR in the next elections (*Fundación Milenio*, 2000a:9).

committing themselves to thoroughly revise the capitalisation process (Paz Rada, interview, 26.5.2004). On coming to power Banzer repeated his promise to defeat poverty and announced he would fight corruption and narco-trafficking and commit to implementing social justice in the country. Since his electoral programme was based on broad concepts rather than concrete policy proposals and his coalition was extremely heterogeneous, governing became rather difficult and few of his electoral promises were kept. Consequently, only few major structural reforms were introduced during this period. The first policy initiative launched in mid-1998 was a reform of the pension system set up by predecessor Sánchez de Lozada (see Chapter 3.8). Other important initiatives of the government were: the project of the National Dialogues[91]; the renegotiation of Bolivia's foreign debt within the framework of the HIPC initiative; some measures to deepen financial sector liberalisation as Bolivia was fully opened to foreign bank operations in 1998; further incentives for foreign investment through the *"Ley Corazón"* which facilitated investment in the border areas of the country; and the so-called *"Plan Dignidad"* aiming to drastically cut the production of coca (effectively the politics of eradication was strongly intensified during the Banzer government). Only a limited number of companies were privatised during the government of Banzer, because most had already changed hands during Sánchez de Lozada's presidency. Despite Banzer's earlier statements the capitalisation process remained untouched. In the eyes of CONDEPA, therefore, Banzer had broken his agreement, which was a major reason for CONDEPA's departure of the coalition in 1998 (Paz Rada, interview, 26.5.2004).

Social conflict. In addition to the lack of an economic vision and a coherent programme social conflicts represented another obstacle to the introduction of wide-ranging policies during the government of Banzer. Particularly in April, September, and October 2000 and also in September-October 2001, there were strikes, civil unrest and road blockades, organised by coca growers, teachers, miners, rural peasants and pensioners who were protesting against various government policies. The police had to intervene in 102 cases of social conflict in the first half of 2001 alone (EIU, July 2001:13). In response to the various protests, the government made concessions to the peasants concerning legislation of land reform, granted a 50 per cent pay rise to the lower ranks of the police

[91] In October 1997 President Banzer called for the First National Dialogue with the purpose of sharing a vision of Bolivia's future between the society and the government. It brought together representatives from a diverse range of groups and came up with reform proposals concerning a wide range of issues, e.g. the revision of labour laws; the obliteration of cocaine production; the modernisation of the Armed Forces; or constitutional reforms.

force and struck deals with the other protesting sectors listed above. The earlier mentioned conflict in Cochabamba made the government re-nationalise the water company. According to the Bolivian think tank *Fundación Milenio* the situation of social unrest experienced in 2000 was only comparable to the highly tumultuous period of 1984-85 (*Fundación Milenio*, 2000b: 42-3).

Change of President. In July 2001 Hugo Banzer was diagnosed with lung cancer and was soon unable to fulfil the tasks of the presidency. He resigned and handed over his office to Vice-president Jorge Quiroga Ramírez in August 2001, at that time 37 years old, who remained in power until the end of the governmental period one year later.[92]

Tax Reforms during the Banzer – Quiroga Government

Table 5.2: Increase of Excise Tax, January 2000

Excise Tax	Previous Rate	Law 28.1.2000	Law 23.11.2000
Cigarettes and tobacco	50%	56%	50%
Vehicles	18%	21% - 33%	18%
Soft drinks	BOB0.18 (per litre)	BOB0.33 (83% increase)	BOB0.18
Alcoholic drinks	BOB1.44	BOB2.00 (39% increase)	BOB1.44

Source: Own elaboration. Based on Ley 2047, 28.1.2000; Ley 2152, 23.11.2000.

Few changes were introduced to the tax system during the government period of Banzer and Quiroga. As regards the main internal taxes the only modification made was an increase in the excise taxes legislated in January 2000. The changes introduced by this law entailed an increase in some rates of the excise tax: cigarettes were now levied 56 per cent (up from 50 per cent previously), a progressive rate from 21 to 33 per cent replaced the former 18 per cent flat rate for the sale of cars (depending on price and fuel); the fixed charge on soft drinks and alcohol was also increased.

By the end of 1999 the government of Banzer was facing a considerable fiscal deficit, mainly caused by the costs of the new pension system (see Chapter 3.8). To balance the deficit the government considered various options such as a fuel price hike or an increase in the rates of the excise tax. According to the Vice-minister of Taxation at that

[92] Banzer died of his illness on 5 May, 2002.

time, Alberto Machicado, he and the people of the Internal Revenue Service were opposed to the latter proposal as they feared higher excise taxes would raise tax evasion. The finance minister and the President were in favour of this increase, however, as it represented the politically easiest measure (Machicado, interview, 25.5.2004). Herbert Müller, then Minister of Finance, gave his own version when asked why the government had opted for a change in the excise taxes:

"I am telling you an anecdote that is not very well known in the country: it was because one of them went outside, it was the Minister of the Presidency, and gave a press conference while we were discussing and so the President could not contradict his minister. It was a bit that the events obliged the President and obliged all of us to adopt this measure." (Müller, interview, 10.5.2004)

According to Müller, the measure was thus a "political accident" given the pre-empted public announcement of the tax increase by a cabinet member. In the subsequent discussion of the proposed tax legislation within the ruling coalition, the UCS opposed the initiative, yet ultimately failed to convince its allies.[93] The government had always argued that these changes to the tax on consumption would prevent an increase in petrol prices. Only a few months later, however, the prices for petrol were raised in April and then again in June (*Fundación Milenio*, 2000a:17). Opposition to the excise tax increase came mainly from the private sector; as Machicado reported the tobacco industry and car importers were literally *"hitting the roof"* and Müller added that rejection was strongly voiced by the CEPB whose President saw himself affected as a producer of wine and spirits (Machicado; Müller, interviews, 25.5.+10.5.2004). Other private sector groups also mobilised against the bill as, for example, did the Santa Cruz-based CAINCO which claimed that the tax bill would cause production costs to rise, making products more expensive and demand decline (*La Razón*, 19.1.2000:B7). When decided upon in Congress, "Law 2047" received a majority of votes by members of the ruling coalition and was approved without any modifications to the executive's original proposal (Müller, interview, 10.5.2004). In a survey of Bolivian business leaders about the greatest mistake of the government during the previous months, the increase of the excise tax was the issue mentioned most.[94] The private sector kept up its pressure and in

[93] It comes as little surprise that the UCS opposed the bill given that its leader, Johnny Fernández, owned Bolivia's principal beer company (*Cerveceria Boliviana Nacional*). However, the influence of the UCS within the coalition (despite holding a significant number of seats) was weak also because at the time the bill was discussed the beer company was involved in a tax fraud scandal. In late January 2000 the Internal Revenue Service published the amounts the company was supposed to pay, which raised the profile of the scandal (*La Razón*, 26.1.2000:B6).

[94] Survey carried out in July 2000 by *Marketing* and *Nueva Economía*, cited in: *Fundación Milenio*, 2000a:26.

November 2000 the government gave in and reversed the increase of the taxes (*Ley* 2152, 23.11.2000).

Reform of Internal Revenue Service. Reforms were initiated in other aspects of the tax system during the Banzer – Quiroga government. In early 2000 two bills were presented to Congress: one to implement a new tax code[95] and another to reform the Internal Revenue Service. The former experienced a long delay as its suggestions proved too contentious and a new tax code was ultimately only introduced in 2003. The latter bill, however, went ahead during the Banzer – Quiroga period and the so-called *Law of Institutionalisation of Internal Revenues* was approved by Congress in December 2000 (*Ley* 2166, 22.12.2000). The reform had two main elements: firstly a directorate (executive president and five directors) was elected by Congress for five years (instead of annual appointments of a new leadership). The President would propose names which would need confirmation by a two-thirds majority in the legislature. Secondly, the selection of personnel underwent a significant change, as the employees of the Internal Revenue Service (SIN)[96] were now chosen by professional entry exams. Bolivia's Internal Revenue Service was generally considered to be a hugely politicised and corrupt body. Eduardo Antelo, Vice-Minister of the Budget at that time, explained (referring to the Internal Revenue Service and the customs authority):

"The political presence in these institutions has always been quite strong; they were seen as institutions of collection not only for the state but also for the political parties" (Antelo, interview, 24.5.2004)

In a World Bank survey, the respondents considered that 75 per cent of the employees at the Internal Revenue Service had been chosen for political reasons (World Bank, 2000a:9). Previously, every government used to appoint a new director to the Internal Revenue Service to have somebody loyal to their parties installed. A change of director usually implied a change of a large part of the personnel too, which was obviously detrimental to continuity in the reform process as pointed out by the former director of this body, Juan C. Pereira (Pereira, interview, 28.5.2004). Apart from the negative impact on the efficiency of reform and collection, these arrangements also made the organisation prone to corruption and turned it into *"booty of the political parties"*

[95] The *Código Tributario*, or tax code, is here defined as regulating the relations between state and taxpayer, the tax administration, the rights and duties of tax collectors, as well as penalties. Tax rates are established by individual pieces of legislation and do not form part of the tax code.

[96] With the introduction of the institutionalisation law the Internal Revenue Service was named *Servicio de Impuestos Nacionales* (SIN); previously it was called *Servicio Nacional de Impuestos Internos* (SNII).

(Trigo, interview, 20.5.2004). It is hardly surprising then that the political parties were opposed to the new legislation. In consequence the new law experienced considerable delay: though presented in early 2000 it was only approved in December of the same year; the actual implementation then suffered another delay as a new director was elected by Congress in autumn 2001 (EIU, October 2001).

Despite the opposition of the political parties, however, the new legislation was passed and implemented due to support from the ruling coalition. Eduardo Antelo described the process as being extremely difficult but considered that public opinion and the media had helped: cases of corruption within the Internal Revenue Service had been subject to public discussion as the media frequently reported on these cases, with photos and articles making the headlines of the newspapers. This pressure to reform the Internal Revenue Service hence made it impossible for the political parties to directly oppose the executive's reform initiative (Antelo, interview, 24.5.2004).

This institutionalisation process of the Internal Revenue Service has generally been evaluated very positively. The leadership of Executive President Eduardo Zegada at the SIN has often been praised (Muñoz, interview, 11.5.2004). Appointed in 2001 he was the first head to have lasted for three governments (Quiroga, Sánchez de Lozada, Mesa), which can be considered as an indicator for the success of the reform.[97] Secondly, the announced fight against corruption seems to have impacted on the de-politicisation of the SIN (Serruto, interview, 31.5.2004). In another area, however, the reform process has so far not produced a significant change: according to Carlos Otálora, Tax Superintendent for La Paz, while tax collection has increased, it has not been due to a greater efficiency of the tax administration but due to higher collections through the customs (Otálora, interview, 12.5.2004).

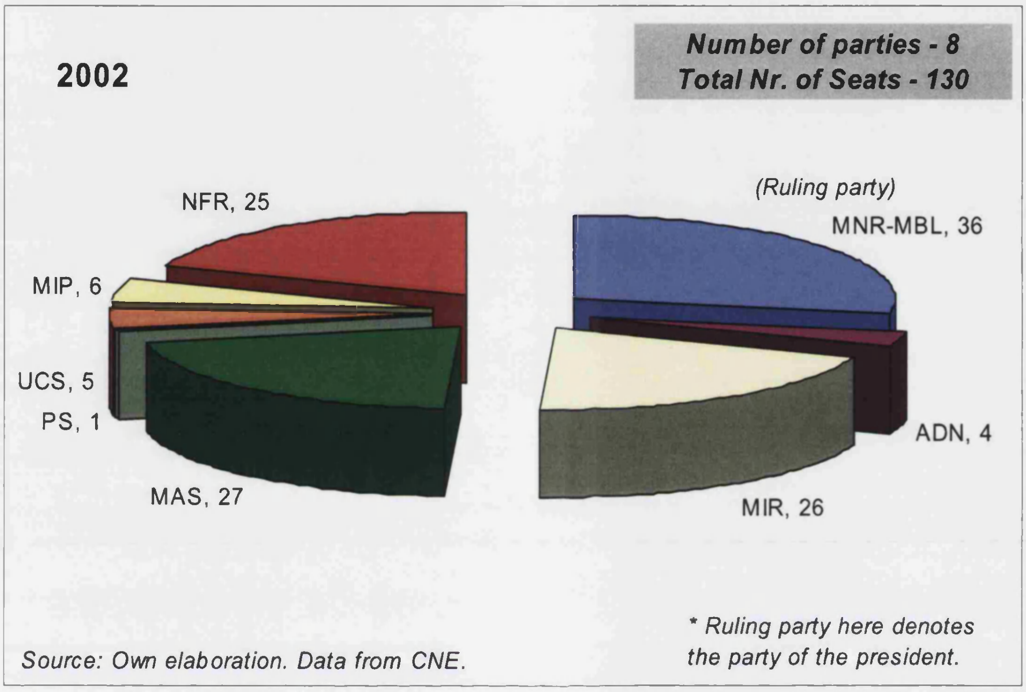
5.2 The Second Government of Sánchez de Lozada (2002-2003)

The elections taking place in May 2002 produced rather surprising results: while Manfred Reyes Villa of the NFR was leading in the opinion polls for weeks before the elections, he ended up in the third place only (20.91 per cent) and the winner turned out to be Gonzalo Sánchez de Lozada (who had already governed between 1993 and 1997). While he and his MNR gained 22.46 per cent of the votes, the second placed candidate was a newcomer to the formal political arena: Evo Morales of the *Movimiento al*

[97] On 5 April, 2005 Zegada resigned from the position for "personal reasons". The previous Vice-director, Rafael Vargas Salgueiro, was appointed his successor (*El Deber*, 6.4.2005).

Socialismo (MAS) was close behind Sánchez de Lozada with 20.94 per cent (CNE, 2005a). The results showed that the electorate was highly divided as the three candidates obtained around 20 per cent of the votes.

Figure 5.3: Composition of Lower Chamber 2002, Bolivia



The composition of the Congress showed a balance of forces rather different from previous legislatures. The ADN, which had been one of the two biggest parties in every Congress since 1985, faced collapse as it won only 3.40 per cent of the votes, which translated into four seats in the legislature. CONDEPA, mainly due to internal struggles, had practically disappeared in 2002 (0.37 per cent). The UCS saw its base greatly diminished as it won only 5.51 per cent, down from around 15 per cent previously (CNE, 2005a). Both the MAS and the MIP (6.09 per cent) were new to Congress. Established in 1999 this was the first general election the MAS took part in. Its leader Evo Morales was the leader of the coca workers based in Chapare. The Indigenous Movement Pachakuti (MIP) was led by the Aymara Felipe Quispe, who was also known as "El Mallku". Quispe was also the leader of the *Confederación Sindical Única de Trabajadores Campesinos de Bolivia* (Single Union Confederation of Bolivian Peasant Workers, CSUTCB), which had been a protagonist in the social protests during the Banzer government.

Coalition-building. The negotiations to establish a coalition turned out to be rather lengthy and complicated. Though for a while it looked as if the MNR could reach an agreement with the NFR, this party ultimately refused to enter into a coalition with Sánchez de Lozada. Since the MAS kept its own claim to the presidency, the only possible partner remaining was the MIR. This put the party of Jaime Paz Zamora in quite a strong negotiation position and it managed to gain a high share of government positions in exchange for entering the coalition: six ministers, four governors (out of nine in total), and the Presidency of the Chamber of Deputies (*Fundación Milenio*, 2003:31). The agreement reached between the MNR and MIR – called the "Government of National Responsibility" – was announced on the 25th of July, just ten days before the elections in the Congress. While some analysts considered the entry of the MIR into the coalition as the result of some tactical manoeuvring of Paz Zamora to make the MNR – NFR alliance fail (*Fundación Milenio*, 2003:31); the MIR leader himself asserted that they had entered the pact against their will and that the USA pressured his party to support the government of Sánchez de Lozada:

"They told us, 'Jaime, the USA has only two lists, one of enemies and one of friends. On which side does the MIR want to be, on the friends' or the enemies' one?' 'On the side of the friends, of course.' 'Well then, the government of Goni', who was one of them, 'is strategic for us.' In a conference we had decided not to enter... When I had to announce that we would enter I said in front of Goni and Mesa how difficult it was to love Bolivia under certain circumstances." (Paz Zamora, interview, 19.5.2004)

Paz Zamora thus explained why he entered this coalition in a rather dramatic style and made the USA responsible for this step. While there is evidence that the USA had indeed intervened through its Ambassador Rocha (Gamarra, 2003:314) and while they certainly had an interest to prevent Evo Morales from coming to power, it is unlikely that the MIR entered the ruling coalition fully against its will. Blaming someone else may have been a way to distract from accusations that the MIR was joining the government in order to receive patronage spoils. This, however, was widely considered as the MIR's main motivation to join the coalition and Fernando Romero, who worked together with Sánchez de Lozada in the economic team during Paz Estenssoro's government, maintained that the ruling coalition *"was a political chaos, it was strictly for reasons of convenience and not of convictions"* (F. Romero, interview, 25.5.2004). The UCS became the third member of the coalition. Making use of the fact that the MNR was dependent on their votes, they threatened not to enter the coalition thereby trying to achieve a higher share of patronage. The UCS ultimately received: the Ministry of Justice, the lower chamber's Commission for Human Development, the

Vice-ministry of Alternative Education, and two embassies (*Fundación Milenio*, 2003:37). Having thus achieved the support of the MIR and the UCS, Sánchez de Lozada was elected President on the 5th of August with 84 of the votes in his favour, 43 went to the second placed Evo Morales (PDBA, 2002).

A coalition that was started by the coalition partner MIR saying that it is difficult to love Bolivia when one had to enter a coalition with Sánchez de Lozada was bound to face difficulties. Given an apparent lack of common ground as regards necessary policy measures, already by September internal problems within the coalition appeared and the media termed the government as *"a marriage of separate beds"* (*Fundación Milenio*, 2003:32).

Policies. Sánchez de Lozada's election campaign in 2002 had four main pillars: overcoming the economic crisis, fighting corruption, combating social exclusion, and, most prominently, *"obras con empleos"* (public works with jobs). The MNR's campaign platform stressed the severe economic crisis the country was currently experiencing, and proposed an "Emergency Plan" as a remedy, which entailed the following proposals: implementing measures to reactivate the economy, introducing social policies, deepening the process of institutionalisation, modernisation and increasing transparency of the state. It proposed, furthermore, to restore the regulatory character of the state – while the market would assure efficiency, the state was to guarantee social justice and solidarity (Zegada, 2002:69). This rather social democratic discourse represented indirectly signalling to the electorate that he would introduce policies different from those introduced during his presidency in 1993 to 1997, where he had in fact reduced the regulatory role of the state, to the strong disapproval of large sectors of the electorate. As he had in the 1993 election campaign, he again promised to lower taxes.

On coming to office President Sánchez de Lozada announced the introduction of a "Plan Bolivia" which was mainly aimed at creating jobs but also at restructuring the financial and corporate sectors. In order to avoid the tumultuous state-society relations experienced by his predecessor he set up commissions with various opposition groups such as coca growers, landless farmers or miners. Only two significant pieces of legislation were introduced during the first half year of the government: in November the re-introduction of the BONOSOL (see Chapter 3.8); and a law for the provision of free healthcare for pregnant women and children under the age of five (*Leyes* 2427 +

2426, 28.11.; 21.11.2002). Given the degree of in-fighting prevalent within the ruling coalition agreeing on economic measures was difficult and no other significant reforms were introduced during the second government of Sánchez de Lozada.

The Attempt to Introduce an Income Tax: February 2003

"It was terribly badly managed. If someone wanted to manage something very badly I think they could not do it as well as they did in this case.", was the evaluation of entrepreneur Doria Medina on the government's attempt to introduce a Personal Income Tax in February 2003 (Doria Medina, interview, 25.5.2004). Soon after coming to power the government started to discuss possible changes to the tax system, as a way to bring down the fiscal deficit from 8 to 5 per cent, which amounted to US$240 million. This reduction also formed part of an agreement the government had reached with the IMF (*La Razón*, 30.1.2003). Different ideas were discussed, among them the introduction of a tax on Cable TV and mobile telephoning. Between November and January, however, the deliberations circled mainly around the introduction of an income tax and frequent meetings between the President, the Minister of Finance, Javier Comboni, and the Vice-minister of Tax Politics, Fernando Cossio, on this issue took place (Cossio, interview, 10.5.2004). Ultimately, the executive decided for the following tax measure, which was announced by President Sánchez de Lozada via national television on 9 February, 2003:

a) *VAT and Transactions Tax.* Lowering the VAT to 12.5 per cent (from 13 per cent) and the Transactions Tax to 2.5 per cent (from 3 per cent)

b) *Personal Income Tax alias Changing the Complementary tax to the VAT.* Previously this withholding tax charged at the same rate as the VAT on all income could be offset on the presentation of invoices. This system of collecting invoices was now to be abolished and people were to pay 12.5 per cent on their incomes – with a tax-free threshold of BOB880.

These proposals were sent together with the budget for the year 2003 which entailed a 10 per cent budget cut in spending on the executive, the legislature and the judiciary. They also provided for some salary increases – depending on the sector between 2 and 8 per cent which were generally considered as very low – and also stated that the budget of universities would not be increased. The government stressed that the proposal would not entail the introduction of new taxes (*La Razón*, 7.2.2003). While this was technically true, the elimination of the mechanism to reclaim the tax paid, in practice meant the introduction of an income tax (though disguised under the name complementary tax to the VAT). It was to be different from traditional income taxes though, as it did not allow any of the usual deductions to that tax, for example, for size of the family etc. Given the absence of these deductions, the Bolivian version of the tax on income was set at a lower rate than usually (12.5 per cent). To defend the measure, the executive referred to the unsustainable fiscal deficit; the changes to the taxes were expected to raise US$90 million in additional income for the state (*La Prensa*, 10.2.2003). They also argued that changing the mechanisms of the Complementary Tax to the VAT would correct a dysfunctional system:

"The issue of offsetting the taxes by presenting invoices is a national scandal, everyone produces their own bills. To avoid that this kind of phenomenon continues to happen we will attack this issue." (*El Deber*, 31.1.2003)

The high degree of fraud with invoices is widely known within Bolivia, according to constitutional expert Urioste even a whole *"industry of false invoices"* exists (Urioste, interview, 11.5.2004). Several commentators on the reform, however, for example the former Vice-minister of Tax Politics Machicado (1997-2002), considered that the system should be kept anyway since it provided people an incentive to ask for invoices and thus ensured the payment of VAT. Consequently, it would be better to attempt limiting the falsification of bills (Machicado, interview, 25.5.2004). Yet no matter how hard the government tried to justify the announced tax measure, the negative reaction from all parts of the Bolivian society was unanimous and immediate.

Opposition to the Reform

Political parties. All opposition parties rejected the reform; the most outspoken among them the MAS and its leader Evo Morales:

"It is not possible that the crisis is solved by an 'impuestazo' on the Bolivian people. Our members will be here permanently so that we can jointly organise mobilisations against this 'impuestazo'." (*La Prensa*, 10.2.2003)

"Impuestazo" was to become the word for this attempt of the government to introduce a Personal Income Tax and has the connotation of something being imposed by the President. It is leaned on the term "gasolinazo" used when governments increased petrol prices. While presidents have the power to introduce petrol price hikes simply by decree and can thus really impose it, tax reforms have to be approved by the legislature and an "impuestazo" as it is commonly understood is hence not possible. Given, however, that the tax reform announced by President Sánchez de Lozada was widely perceived by the population as a measure already decided upon rather than a proposal, the term "impuestazo" came to denote not only opposition to the income tax but also against government practices.

The MAS announced that it would carry out its opposition both within the Congress and on the streets and started mobilising its supporters (*La Razón*, 11.2.2003). Together with its criticism of the potential income tax, the party publicised its own proposal: petrol companies should pay 50 per cent royalties instead. The next biggest opposition party in Parliament, the NFR, had a similar alternative proposal, suggesting that the taxes levied on the petrol sector rise to 50 per cent but also that more effort should be made to uncover tax evaders. NFR leaders complained about the "incapacity" of the government and announced their resistance to the tax reform in the legislature and – if unsuccessful there – that they would also call its supporters to carry out civil disobedience (*La Razón*, 10.2.+11.2.2003). The smaller opposition parties in Congress equally spoke out against the initiative of the executive, as did the MIP whose leader, Felipe Quispe, called for mobilisations (*La Razón*, 11.2.2003). Two days after the President Sánchez de Lozada had aired the tax bill on TV, the opposition parties – MAS, NFR, MIP, and PS – declared that they would call the ministers involved in formulating the bill to a vote of censure.[98] While the rejection of presidential initiatives is a usual move on the side of the opposition parties, the fact that several of them did not restrict their protest to the legislative space and instead mobilised their supporters for street protests represented a rather new phenomenon in Bolivian politics. Equally unusual, and more precarious for Sánchez de Lozada, was that his coalition partner MIR also publicly challenged the proposed tax reform (*La Razón*, 12.2.2003).

Private sector opposition. Various business organisations started questioning the announced tax reform soon after it was made public. The CEPB's President, Carlos Calvo, criticised:

"I consider it a real shame that the government, under the influence of the IMF, opted for diminishing the economy by pro-cyclical measures which will intensify recession and unemployment. This 'impuestazo' imposed on the population, apart from considering it unjust, will mean that consumption, investment, and sales will decline and create higher unemployment." (*La Razón*, 10.2.2003)

The CEPB called on the government to withdraw its plans and convened an emergency meeting of its members the day after the measure was announced; by day two of the

[98] The ministers in question were: Oscar Farfán, the Minister of Economic Development; Javier Comboni, Minister of Finance; José Guillermo Justiniano, Minister of Sustainable Development; Juan Carlos Virreira, Minister of Foreign Trade (*La Razón*, 12.2.2003).

publication of the government's plans, the CEPB had orchestrated a media campaign and had placed one-page advertisements in Bolivia's main newspapers criticising the mismanagement of the country's public finances and calling for discarding the economic measures put forward (*La Razón*, 11.2.2003). Other private sector groups were equally alerted and assessed the proposal negatively, as did the Santa Cruz based CAINCO which expected informality to rise in consequence to the introduction of an income tax (*La Razón*, 10.2.2003), an argument which was also presented by the CNI. Its President, Roberto Mustafá, considered that the elimination of the system to present invoices would augment illegal trade, evasion and smuggling and generally complained that those who always paid their taxes would once again be punished (*La Razón*, 11.2.2003). Other private sector organisations – such as the *Asociación de Bancos Privados* (Association of Private Banks, ASOBAN), the *Federación de Empresarios Privados de La Paz* (Federation of Private Entrepreneurs of La Paz, FEPLP) or the *Cámara Departamental de Exportadores* (Departmental Chamber of Exporters, CADEX) – joined in the protest and recommended to improve the administration of existing taxes as an alternative to creating new tax burdens. Analysts and experts in the field mainly criticised the design of the tax: Alberto Machicado, who was Vice-minister of Tax Politics for several years (1997-2002), considered that the executive should have opted for smaller, but progressive tax rates (Machicado, interview, 25.5.2004); Napoleón Pacheco of the *Fundación Milenio* held that the base line of BOB880 was too low and that it would be better to tax only those earning more than BOB3,000 or 4,000 (Pacheco, interview, 5.5.2004).

Trade unions and other sectors. The reaction from the trade unions, principally the COB, was equally swift and uncompromising. Saturnino Mallku, Executive Secretary of the COB, made a public statement saying:

"The income tax affects the great mass of workers who have a salary between BOB800 and 2,500. 80 per cent will suffer the consequences of this tax... Again economic, political, and social responsibility is burdened on the worker's shoulders. We don't have an alternative to taking protest measures." (*La Razón*, 10.2.2003)

In a direct response to the TV message of Sánchez de Lozada, the COB sent a letter to the President asking him to stop the implementation of the economic measures and announced a national strike for the 13th of February (*La Prensa*, 10.2.2003). The plan to hold a 24 hour strike on that date won more and more supporters as other sectors promised to join in and organise demonstrations to force the government to withdraw the *"impuestazo"* (*La Razón*, 11.2.2003). Two days after the tax measure was publicised the Federation of Universities of Bolivia held an extraordinary Congress during which they rejected the income tax, declared a state of emergency for the universities, and organised mobilisations. Their protest, however, was not purely aimed at the tax increase but also against the government's refusal to increase the funds for higher education in the budget presented. The powerful CSUTCB led by Felipe Quispe proclaimed that while they did not see themselves affected by the measures they would join in the mobilisations together with the other sectors of society. Altogether a wide range of other organisations and sectors joined in the rejection of the government's plans, including the Bolivian Society of Engineers, the Association of Lawyers, the health workers, the teachers' union and the Association of Economists (*La Razón*, 11.2.+12.2.2003).

The events of 12 and 13 February. *Police mutiny.* While the diverse sectors of Bolivian society thus started to mobilise against the measure, the protest turned into a state crisis when the Bolivian police went into mutiny three days after Sánchez de Lozada announced his economic plans on TV. The police had demanded a salary increase for a while, however, the budget that was sent together with the tax measure provided that their salaries would only be increased by 2.2 per cent. This was less than the increase for the other sectors and even below the previous year's inflation rate of 2.3 per cent (*La Razón*, 10.2.2003). In the morning of the 11th of February some police units in La Paz did not take up their work and the actual mutiny was launched at 14.00 by the *Grupo Especial de Seguridad* (Special Security Group, GES).[99] *"The salary we earn is a misery and the 'impuestazo' affects the whole population"*, maintained a mutinous policeman (*La Prensa*, 12.2.2003).[100] The police's demand was a 40 per cent (later 50 per cent) increase of their salaries as well as the withdrawal of the income tax.[101] Within hours other police units, mainly in La Paz but also in other parts of the country, joined the mutiny. The capital and other parts of the country remained without police vigilance and in the evening of the 11th, government officials started negotiating with the police.

[99] The GES has around 450 members and is Bolivia's best trained police unit. Its tasks include: to reestablish public order when necessary; to protect the legislative palace and other public institutions; and to assume counterterrorist functions. It is based around the corner from the presidential palace and Bolivian Congress and by going on strike neglected their duty to protect these buildings. The GES had already been the principal force behind a police mutiny in 2000 during the government of Banzer, which resulted in the government granting a 50 per cent salary increase to the police (*La Razón*, 12.2.2003:C3).

[100] A lower rank police officer was earning BOB800 per month, a sub-lieutenant BOB1,000 and 1,200, sergeants and lieutenants BOB1,500 (*La Razón*, 12.2.2003).

[101] These were the principal demands though a long list of other things was made, as, for example, claims for food vouchers. For the list and more information on the police mutiny, see: *Fundación Milenio*, 2003:70-74.

According to the *Fundación Milenio* the government gave in to 70 per cent of the police's demands – apart from the one to withdraw the tax measure – in the course of that night (*Fundación Milenio*, 2003:72). However, the police units did not accept this agreement as they insisted in the rejection of the *"impuestazo"* and the mutiny continued. Napoleón Pacheco evaluated the police mutiny as follows:

"The position of the Sánchez de Lozada government was completely wrong because he stated that he would not negotiate with the police under pressure. But the measures of pressure of the police were extended, more units joined in the strike and obviously in this context – which was at two or three days after the creation of the income tax was issued – this acted like a kind of catalyst for the protest because the rebelling police affirmed in their discourse that they opposed the creation of new taxes against the people and obviously this discourse spread out." (Pacheco, interview, 5.5.2004)

The next day, the 12th of February, events in La Paz accelerated. In the morning students of a nearby high school (*Colegio Ayacucho*) gathered on La Paz's main square, the Plaza Murillo. Protesting against the government's measures they threw stones against the main government building and thereby marked the beginning of a conflict that would turn out to be violent. Members of the GES also assembled on the Plaza Murillo and fired tear gas on government buildings, for the protection of which they were originally hired. At 11.00 President Sánchez de Lozada called in the army to restore order and to protect public buildings. With the army present on the Plaza Murillo confrontations between them and the police occurred during the following hours and 10 policemen and four soldiers were killed.[102] More and more civilians gathered in La Paz's city centre to protest against the government's plans. At 16.00, at the peak of the conflict, President Sánchez de Lozada gave a message on the national television, in which he called for an end of the conflict and announced the withdrawal of the tax bill. Ironically, it was on this day that the executive's proposal for the new tax legislation had reached the legislature. As Alvaro Villegas, who was part of the economic team developing the tax reform, narrated they had been in the process of presenting the bill to the legislature when they were overtaken by the events outside the legislative palace:

"The day that we first discussed in the Senate and in the specific commissions about these issues – ... in the moment we were explaining someone knocks on the door asking us to vacate the building as they were surrounding the Palace." (Villegas, interview, 28.5.2004)

Though the trigger of the conflict was thus withdrawn, the protests and mutiny continued until an agreement with the police – including a 50 per cent salary increase –

[102] Resentments between police and military are based in Bolivia's history as during the1952 revolution the army defended the incumbents of the regime while the police supported the MNR-led revolution.

was reached the next day (for an overview of the events of the 12th and 13th of February see Table 5.4).

Table 5.4: Chronology of the 'Impuestazo', February 2003

9 February		President Sánchez de Lozada announces the introduction of a Personal Income Tax on TV.
10 February		Widespread mobilisations against the "*impuestazo*" begin.
11 February		A police unit in La Paz refuses to go out on street patrols.
	14.00	Police unit, GES, goes into mutiny, other units follow. The police demand the withdrawal of the income tax and a 50% increase in their salaries. La Paz remains without police vigilance.
	19.00	Government starts negotiations with police.
12 February		Executive's tax project received by Congress.
	10.00	Students assemble on Plaza Murillo and throw stones at government palace. GES fires tear gas at the building.
	11.00	President calls in the army to intervene and take control of Plaza Murillo. During the following hours confrontations between the military and the police and protesters occur. 10 policemen and 4 soldiers are shot.
	16.00	In a television message President Sánchez de Lozada withdraws the tax measure in an attempt to pacify the situation.
	from 17.00	Public buildings – as the Ministry of Labour, the Vice-presidency, the Ministry of Sustainable Development, and the party headquarters of the MNR, MIR and UCS – are looted and burned by civilian protesters.
		During the night – further looting and vandalism occurs – of shops, a beer brewery and other business premises.
13 February		Protests organised by the COB; supporters of political parties MAS, PS and NFR join in, Miners' Union and other sectors of civil society. Calls for resignation of Sánchez de Lozada. In confrontations several civilians are shot, many injured. Later on the government would be accused of having placed snipers. Further looting and acts of vandalism occur, mainly in El Alto.
	16.00	Police accepts agreement with government and takes up its work again. The situation in La Paz and other parts of the country goes back to normal.
		33 people die and ca. 200 are injured on 12 + 13 February.

Source: Own elaboration.

Why the Reform Failed

The planned tax measure was withdrawn by Sánchez de Lozada in consequence of a police mutiny and a popular uprising. At that time the bill had barely reached the institutional level, as on that day the executive's proposal had just arrived at Congress and was about to be discussed. At least as regards tax reforms this course of events was unprecedented since the beginning of political stability in Bolivia in 1985. Why did the attempt to introduce an income tax in February 2003 fail, and what triggered the popular uprising against the measure?

Communication (or lack thereof). As several interview partners pointed out there were serious problems of communication concerning the proposed income tax reform on the side of the government as well as bad management (Interviews: Antelo, Blanco, Cariaga, Cossio, Doria Medina, Machicado, Millares, Morales, Muñoz, Talavera, Villegas, for dates see Appendix B). The influential entrepreneur and one of the main heads of the MIR, Samuel Doria Medina[103], referred to the mixed messages coming from the government during the months preceding February:

"In September they informed us that they would increase taxes; in October they said we will not raise taxes but we will tax phone calls and mobile phones; in November they said something else – they changed permanently." (Doria Medina, interview, 25.5.2004)

The government took quite a long time to develop the tax legislation with which they hoped to limit the fiscal deficit; they also gave ambiguous signals to society about the reforms planned. Only a few days before the planned tax changes were announced, the Minister of Finance, Javier Comboni, publicly stated on the 3rd of February that no tax on salaries would be levied (*Opinión*, 5.2.2003). According to Central Bank President Morales the government made a mistake by denying that this reform would be introduced: *"The government communicated its intentions very badly. Firstly, it denied that this tax was going to happen, and afterwards they released it, so the population felt deceived."* (Morales, interview, 24.5.2004)

Once the executive managed to come to an agreement about the tax bill, this inconsistent course was not rectified by a coherent attempt to convince the other political parties, interest groups and the wider population about the reform's advantages. On the contrary, after President Sánchez de Lozada announced the measure on TV, few

[103] After a conflict with Paz Zamora, Doria Medina left the MIR in late 2003 and set up his own party, the *Unidad Nacional* (UN). He is one of the main candidates for the presidential elections in December 2005.

further explanations were offered and those given were often confusing. Even the person responsible for the reform, Vice-minister of Tax Politics Fernando Cossio, admitted that there was a lot of misinformation; and former Minister of Finance, Edgar Millares, claimed that the vice-ministers had tried to confuse the people (Cossio; Millares, interviews, 10.5.+29.4.2004). In the weeks prior to the announcement the government had repeatedly stressed that any proposed reform would make those who "earned more, pay more". From these declarations it was to be expected that the government would come up with a highly progressive tax. In his televised message, Sánchez de Lozada emphasised again that *"it would be a tax which affects those who have a higher income"* (*La Razón*, 11.2.2003). In fact, however, the proposal was to put a flat rate of 12.5 per cent on all salaries regardless of their level. Additionally, this flat rate did not represent an altogether regressive form of taxation given the provision that the amount of two minimum salaries was to be deducted before any payments. Thus, the effective rate would actually be less than 12.5 per cent and would depend on salary level. For example, someone who earned BOB1,000 would deduct BOB880 and then pay 12.5 per cent on the remaining BOB120; someone earning BOB5,000 would pay 12.5 per cent on BOB4,120; thus the higher the salary the less the deduction of two minimum salaries would make a difference and the closer to an effective rate of 12.5 per cent the taxation would get. Given this mechanism the tax on income was "slightly progressive". The explanations given and media presentation led to a great deal of confusion about the nature of this tax. As Eduardo Antelo, previously Vice-Minister of the Treasury, pointed out:

"In the moment when it was presented, came out in the press and was explained in the form of calculations so that every person could calculate how much tax they would be paying, they put what you earn in the first column, deduced the two minimum salaries in the second column and in the third column the same rate was applied, so it appeared as if everyone paid the same tax, the one who earned BOB1,000 or the one who earned BOB20,000. So it was not something very intuitive and the people said that this is not what the President is saying... the headlines of many newspapers said that the government is lying." (Antelo, interview, 24.5.2004)

Minimum salaries. This apparent contradiction in the government's "taxing the rich" discourse was aggravated by the decision to tax anyone earning more than two minimum salaries, equalling the amount of BOB880 (ca. US$117). By contrast, the current version of the "Complementary Tax" to the VAT allowed for an exemption of four minimum salaries. As was explained later on, and confirmed by several people involved in the creation of the tax bill, the government considered the proposal of two minimum salaries only as a starting position for the negotiation in the Congress, where they expected to have this exemption raised to at least four minimum salaries (Cossio; Villegas; Otálora; Talavera, interviews, 10.5.+28.5.+12.5.+20.5.2004).

"The President took the additional decision to enter with the position of two minimum salaries so that in the Congress he could concede up to five minimum salaries and thus leave teachers and police outside. This was his real stance but in the culture of political negotiation, with the experience of the President if he would enter with a proposal of five it would be increased to ten, so he entered with a proposal of two... It never reached the Congress and the story was over... The approach of the President is understandable; it had, however, a devastating effect as the people believed that it would really be two minimum salaries, which is very tough." (Gray-Molina, interview, 7.5.2004)

Gray-Molina, who was involved in setting up the tax reform as the head of the governmental think tank UDAPE, also reported that the original proposal contained a higher number of minimum salaries and also a differentiated tax rate (thus being more progressive). According to his account, the original proposal was then changed by the President, the Minister of Finance, and the Vice-minister of Tax Politics (Gray-Molina, interview, 7.5.2004). In retrospect these changes can only be considered as a significant political mistake, which raised the level of resistance against the measure. A tax with differentiated rates, levied on those earning an amount equal to a higher number of minimum salaries, might have led to a less severe reaction in the population. Given the proposal put forward by the government, however, it was perceived as an unjust tax that would affect the great majority of people instead of being a form of "taxing the rich" as the President had announced.

Simultaneity of budget and tax reform. While the failures in communicating and conceptualising the tax bill played an important role in triggering the massive protests, other factors had an equally negative influence. The tax legislation was put forward by the government at the same time as the budget for 2003. Eduardo Antelo considered this as contributing to the situation that was to evolve:

"You had political fronts opened with all sectors that somehow depend on the state ... you were in fact in a difficult process of negotiation about this (the salary increase, SL) and additionally you were reducing their salary levels because you were putting a tax on them." (Antelo, interview, 24.5.2004)

The presentation of the annual budget and particularly the provisions for salary rises are traditionally contentious. In the case of the budget presented in February 2003, the increase in salaries was very low and left many sectors dissatisfied. In fact, it was this issue which apparently made the police decide to go into mutiny, which in turn triggered the events of the 12th and 13th of February. The provisions for the budget opened political fronts with other sectors as well: for example, the universities heavily opposed the decision not to increase their budget line yet simultaneously called for the withdrawal of the tax proposal. While sending the tax bill together with the budget thus seems to have been a mistake, the simultaneity argument has its limits given that many of the previous tax reforms were sent together with the budget and introduced successfully.

Recession. Another aspect often considered as dooming the tax reform attempt to failure was the economic situation in Bolivia. Former Minister of Finance, Fernando Candía, stated:

"You don't do this in times of crisis, no one charges taxes in crisis, no one increases taxes in crisis, and no one creates new taxes in crisis and I believe that this has been the main error in February. The state evidently needed funds – that is undeniable. However, the economy was and still is so depressed that charging an additional tax was simply putting a powder keg on fire, it was going to burst in any case, so it was something very foolish." (Candía, interview, 6.5.2004)

The strong reaction of society against the government's attempt to implement an income tax in February 2003 was exacerbated by economic recession. Apart from the political difficulties, several commentators also condemned the measure on technical grounds: charging taxes during recession would lower consumption and savings, which in turn would aggravate the recession further (Candía, interview, 6.5.2004).

Inexperienced ministers. Several interview partners also considered that President Sánchez de Lozada had made a mistake in the choice of his ministers. Entrepreneur Doria Medina said:

"They had a Vice-minister of Tax Politics who was very young and without any experience ... Cossio with all his inexperience carried out this wrong project, badly done, badly explained, so it did not work because they had done badly." (Doria Medina, interview, 25.5.2004)

One apparent mistake was a largely technocratic approach to the tax reform which took little account of its political feasibility. Fernando Cossio, Vice-minister of Tax Politics, described the tax bill they put together: *"It would have made the Bolivian tax system like a text book... with the President we wanted to get an absolutely pure law."* (Cossio, interview, 10.5.2004). This comment makes clear that Cossio had previously not considered the political aspects, but focused on technical criteria. He did not consider that a piece of legislation – though possibly technically perfect – might ultimately not go through. Ministerial lack of experience might therefore have contributed both to conceptual mistakes of the tax reform, and the failures in communicating and explaining the reform after its announcement. Ultimately, however, launching the bill was the decision of Sánchez de Lozada so the strategic mistakes involved were mainly his responsibility.

Mistakes of Sánchez de Lozada and weak coalition. Given the failures outlined it remains to be asked why Sánchez de Lozada did not anticipate the massive opposition this tax bill would trigger. Between 1993 and 1997 he had governed next to unchallenged and had introduced several major economic policies. The Bolivian economist Cariaga considered that *"Sánchez de Lozada believed that he could do as he liked, as he had done during his previous government and he met with a lot of resistance"* (Cariaga, interview, 21.5.2004). On coming to power Sánchez de Lozada put a lot of energy into forming a coalition, which was fragile from the start, however. Relations between the MIR leader Paz Zamora and Sánchez de Lozada had been quite conflictive and the two parties rarely managed to reach consensus on economic policies. In the case of the tax reform undertaken, Sánchez de Lozada had apparently not reached a proper consensus with his coalition partners. Paz Zamora claimed that their opinions were not taken into account (Paz Zamora, interview, 19.5.2004). In the course of the conflict the MIR distanced itself from the initiative signalling that not even the coalition partner of the ruling party agreed to the proposed tax reform. This meant that the tax measure appeared as a purely executive-led initiative with next to no supporters within the Congress. Jaques Trigo, finance minister during the previous government, considered that Sánchez de Lozada made a mistake in not negotiating the tax measure:

"The error that Sánchez de Lozada made was his failure to negotiate the so-called 'impuestazo'*... in the Congress. I think he should have negotiated first in the Chamber of Deputies or with the political parties, including the MAS, and in the Senate... and only then launch the* 'impuestazo' *so that the* 'impuestazo' *could be ... an initiative of the Congress instead of being an initiative of the executive. So this was a political mistake because the truth is that you cannot pass any law, less so one of taxation or the like, if it is not negotiated with the Congress. If you have no ally in the Congress the law does not pass."* (Trigo, interview, 20.5.2004)

Apparently the measure was not even fully supported by the ruling party MNR itself, which asked for modifications and an internal argument evolved. During the two-day conflict it was reported that the majority of the MNR's legislators wanted to have all ministers related to the economic team responsible for the reform leave the cabinet (*La Razón*, 13.2.2003:A22).

In addition, introducing this tax meant breaking an explicit electoral campaign promise to lower taxes. Sánchez de Lozada had already failed to keep the same promise when he came to power in 1993; during his presidency he did not reduce any taxes and even increased some (for example, the transactions tax). Lozada's second U-turn made the population even more reluctant to accept the measure.

Legitimacy. When winning the elections, Sánchez de Lozada was only supported by about one-fifth (22 per cent) of the population, hardly a strong mandate to govern. He was rejected by large sectors of society who were highly critical of his previous period of government 1993 – 1997. Accordingly Fernando Romero, who was with Sánchez de Lozada on the team to develop decree 21060, maintained that the conflict of February 2003 came about for the following reasons:

"I think this was used by the anti-Sánchez de Lozada movements. I think that this is also strongly linked to the enormous weakness and fragility and the enormous concept of favours with which Sánchez de Lozada established his coalition during his second government... The forces against President Sánchez de Lozada were desperate, as from February the intention was to make Sánchez de Lozada leave, he had no legitimacy and a very low support of 22 per cent of the vote." (F. Romero, interview, 25.5.2004)

Since the day of the election then, the government lacked legitimacy within Bolivian society and the events of February 2003 also expressed a larger social discontent with the Sánchez de Lozada government. Tax Superintendent Ramiro Cabezas described the attempted tax reform as *"the last straw to break the camel's back"* (Cabezas, interview, 29.4.2004), which made large sectors of society express their opposition to the measure and to the government on the streets.

External influence. Within Bolivia there was a widespread belief that the attempt to introduce an income tax was something that the IMF had tried to impose; statements like the one of Saturnino Mallku of the COB saying that *"the government is carrying out the recommendations and impositions of the IMF"* expressed a common evaluation of the situation (*La Razón*, 10.2.2003:12). During the first months of the Sánchez de Lozada government negotiations with the IMF about a credit package were undertaken and almost finalised at the end of January 2003, which would have allowed Bolivia to receive credits of about US$4 billion from the World Bank, the IDB, and the *Corporación Andina de Fomento* (Andean Development Corporation, CAF) under a three-year programme (*La Razón*, 10.1.+30.1.2003). The condition attached to the agreement was lowering the fiscal deficit from 8.5 per cent to 5.5 per cent (*La Razón*, 22.3.2003).[104] The decision to choose the income tax to reduce the deficit seems to have been an independent decision of the economic team of Sánchez de Lozada. Central Bank President Morales explained that *"The recommendation of the IMF is not about this tax, but about reducing the deficit."* (*La Razón*, 12.2.2003:C11). And President Sánchez de Lozada mentioned in an interview that the policy advised by the IMF was to carry out a petrol price hike (*La Razón*, 11.2.2003:C6-7); finally, the IMF itself denied having proposed tax increases to the Bolivian government (*La Razón*, 15.2.2003:14). While some external pressure thus existed to undertake measures to lower the deficit, no specific policy recommendations were made and the tax reform proposed was developed by the government's economic team. As many economic analysts pointed out the situation of such a high fiscal deficit was unsustainable, thus measures to reduce it would most likely have been undertaken even in the absence of an agreement with the IMF. What did play a role, however, was that much of the public perceived the government as blindly following the IMF's recommendations, which further discredited the government and made the tax measure appear not really necessary.

Summary. The failure of the income tax due to popular protest can be explained by various factors: the government failed to communicate its proposal effectively and a strategic error was made by setting the exemption rate at two minimum salaries only. The timing of the reform represented a further difficulty: Bolivia was experiencing an economic recession and the tax bill was sent together with the annual budget which alone would have sparked significant opposition given the low salary increases it provided for. Furthermore, introducing any economic reform would have been difficult for Sánchez de Lozada given his lack of legitimacy and extremely fragile government coalition.

The Sánchez de Lozada Government after February. Though the calls for the President's resignation became more and more widespread during the conflict, Sánchez de Lozada survived the events of February, though with his government severely weakened. In an opinion poll carried out after the February events, Sánchez de Lozada had a support rate of only 21 per cent (*Fundación Milenio*, 2003:33). In August 2003 the NFR of Manfred Reyes Villa became a member of the ruling coalition. The coalition of MNR, MIR and NFR provided President Sánchez de Lozada with a two thirds

[104] After the events of the 12th and 13th of February the negotiations about the agreement were resumed and modifications introduced. The IMF agreed to soften the conditions and required a deficit reduction of only 2% instead of 3%. Ultimately, however, the programme was not implemented as the political upheavals of February and October 2003 made it unviable.

majority in Congress – 105 out of the 157 seats (in both the upper and lower chamber) (EIU, October 2003:4). After joining the government NFR leader Reyes Villa saw his popularity rate fall to half its previous level (EIU, October 2003:13). Since it was foreseeable that joining an unpopular government would not go down well with NFR followers, the primary motivation to join obviously seemed being able to get hold of government spoils. At the end of the negotiations the NFR received three ministries (Labour, Sustainable Development, and Financial Services), and nine vice-ministries in exchange for their support of the Sánchez de Lozada government (*La Razón*, 6.8.2003). Only a few months after Sánchez de Lozada had reduced the size of the cabinet in March in order to reduce public spending[105], these side-payments required an increase in the number of ministers from 13 to 15, several new vice-ministries and other positions were also established. When analysing the process of incorporating the NFR into the government, Juan Antonio Morales, President of the Central Bank, considered it as being dominated by the discussion about the distribution of positions:

"As a consequence of February the government tried to extend its political base later and tried to incorporate other people, the NFR as well, but it lost so much time to discuss positions, who would go to which public office, and the economic crisis continued and thus it happened what happened in October." (Morales, interview, 24.5.2004)

Tax code.[106] Soon after the NFR entered the coalition a new tax code was approved. The previous tax code had been valid since 1970 – with a few changes being introduced during the government of Paz Zamora – and was generally often considered too lenient on evaders (Muñoz, interview, 11.5.2004). Already during the Banzer government a new tax code had been put forward. Former finance minister Herbert Müller reported this was not passed due to the opposition of the private sector and the main opposition party, the MNR (Müller, interview, 10.5.2004). Once in power, the MNR took on this project and ultimately introduced a tax code very similar to the one formulated by its predecessors (Machicado, interview, 25.5.2004). Opposition to the tax focussed on prison sentences for certain cases of tax evasion. This aspect was still opposed mainly by the private sector when the tax code was discussed in Congress in July 2003 and the government made some changes as a result. Apart from the private sector there was little awareness outside the Congress about the changes to the tax code undertaken. With the help of the votes of the MNR, MIR, NFR, UCS, and ADN – the tax code was

[105] The so called Ley LOPE, *Ley de Organización del Poder Ejecutivo* (Law of Organisation of the Executive Power), entailed a budget cut of 10% in the spending on the executive power. It restructured the executive and among other changes ministries were reduced from 16 to 13 (*Ley* 2446, 19.3.2003).

[106] See definition in Section 5.1.

approved in late July (*Ley* 2492, 2.8.2003). Its full implementation was delayed by several changes introduced during the government of Carlos Mesa from October. Some aspects of the code were softened, for example, the time scale for repaying tax debts was extended.

October 2003. The newly established ruling coalition did not last for very long. As of September 2003 a series of anti-government protests evolved, which – according to John Crabtree (2005:101-2) – were triggered by three main issues: a) in El Alto the mayor attempted to change local property tax administration. People feared that this administrative measure meant an increase in tax and mobilised against it ultimately forcing the mayor to withdraw the plans; b) in the Altiplano the peasant federation of Felipe Quispe organised road blockades in an attempt to make the government yield to a list of demands; c) thirdly, a huge demonstration took place in La Paz on the 19th of September where thousands of protesters voiced their rejection of the government's plans to export gas and called for a referendum on the energy policy of the country. Discussions about what to do with the country's large natural gas reserves had been going on for a while. A recent project proposal from a private sector company to export gas via a port in Chile to the USA – which the government had not fully accepted yet but seemed to favour – was perceived by the population as a done deal. It was heavily opposed by various social groups and led to the demonstration aimed to make the government rethink its plans.

This chain of events led to a gradually evolving protest movement unified by its joint rejection of Bolivian gas exports via Chile to the USA and by its opposition to the Sánchez de Lozada government. As the conflict intensified, the government called in the police and the army to bring the protests to an end. In the second week of October the confrontation escalated and 59 – predominantly civilian – people were killed. In the course of these events, the President gradually lost what had remained as his support base as coalition partner NFR withdrew and Vice-president Carlos Mesa distanced himself from the President and as even the urban middle class no longer backed his government. On the 17th of October Sánchez de Lozada resigned and went into exile to the USA after having been in power for only 14 months. In the evening of the same day the Congress accepted his resignation. As prescribed by the Constitution Vice-president Mesa was sworn in as Bolivia's new President.

5.3 THE GOVERNMENT OF MESA (2003-2005)

On coming to power President Mesa, a well-known television broadcaster and historian, promised to fulfil several demands that were voiced during the protests of the preceding weeks: he announced to hold a referendum on gas exports and to convene a constituent assembly to carry out political reforms. For the latter he established a congressional commission which would define the powers, scope and representation of the constituent assembly. In another attempt to distinguish himself from his predecessor's government, Mesa also emphasised that he would govern without political parties. Napoleón Pacheco, Director of *Fundación Milenio*, commented on this approach:

"The government of Carlos Mesa is characterised by a disdain for the political system with the argument that the population is tired of the politicians. And evidently a large part of the Bolivian population is tired of the politicians because of the corruption, because they don't work, they don't do their job as they should do." (Pacheco, interview, 5.5.2004)

Being a political independent himself, Mesa broke with the model of the past and decided he would govern without a formal coalition in Congress. This way he distanced himself from the model of a coalition politics dominated by patronage in recent years and also from the traditional parties in general, which had become largely discredited within society. From the beginning Mesa enjoyed rather high popularity rates reaching 67 per cent in November 2003 and holding at 60 per cent by July 2004 (*Fundación Milenio*, 2004:33). Regarding policy initiatives, an important legislation of February 2004 introduced constitutional amendments aimed at increasing popular participation within the democratic system. The bill's principal changes were: a) the possibility to convene a referendum on controversial matters of national interest; b) the mechanism to convene a constituent assembly for proposing constitutional amendments; c) a right for the public to present legislative initiatives along with the executive and the legislature; d) the possibility for independent candidates and those of social movements to stand in general and municipal elections thus ending the monopoly of political parties (EIU, May 2004:13-14).

Referendum and hydrocarbons tax. By far the dominant policy issue on the agenda of the Mesa government was related to the referendum on gas exports and the related issue of a new hydrocarbons law. The referendum was convened for 18 July, 2004 and aimed to give the population a say in the government's policies toward the hydrocarbons sector and the question of the gas exports. To test public opinion on these issues five questions were formulated, which were widely considered as being confusing and rigged towards eliciting the answer favoured by the government. The result was positive for President Mesa as an average of 77 per cent of the voters answered positively to the questions and the general turnout of around 60 per cent was rather high (EIU, August 2004:7). John Crabtree described the results:

"On three of the questions – the repeal of the existing hydrocarbons law, the assertion of national ownership of hydrocarbons at the wellhead and the strengthening of YPFB – the "yes" vote was well over 80 per cent. On the two others – the use of gas to negotiate with Chile and the approval of gas exports subject to meeting local industrial demand – the margin was lower, but well over half." (Crabtree, 2005:107).

While the referendum provided President Mesa with a certain mandate, translating this mandate into policies was still difficult since the questions were ambiguously formulated and open to interpretation and also any legislation – referendum or no referendum – required the approval of the Congress. Mesa put forward a proposal to reform the hydrocarbons law in February 2004: a "complementary" tax on the hydrocarbons sector (in addition to the 18 per cent royalty payment). This "complementary" hydrocarbons tax would incrementally raise taxes on oil fields: depending on their level of production they would pay up to 32 per cent of additional taxes. Though President Mesa hoped that the results of the referendum would provide him with enough backing to go ahead with introducing this legislation, the bill experienced considerable delays in Congress and led to a crisis of government in early 2005. Several opposition parties – principally the MAS – blocked the introduction of the bill as they considered it far too lenient.

Mesa's Attempt to Introduce a Tax Reform

Given that Mesa inherited a precarious fiscal situation from his predecessors, measures to either reduce spending or increase income had to be taken sooner or later and a few months after coming to power different ideas concerning a possible tax reform were circulated by the executive. The Minister of Finance, Javier Cuevas, for example, announced in early January that changes to the Complementary Tax on VAT were to be introduced (*El Diario*, 6.1.2004). During the following weeks several options were discussed, among them, for example, reimbursing those earning more than BOB4,000 only 6.5 per cent of the 13 per cent withholding tax (*El Diario*, 13.1.2004). Other possibilities considered by the government were variations of this proposal. In the media comparisons were made to the *"impuestazo"* that Sánchez de Lozada tried to introduce in February 2003 (though in fact the proposals were rather different). After several weeks of discussion the government dismissed the idea in a press conference given by Finance Minister Cuevas (*La Razón*, 21.2.2004). Soon after the plan to tax income was given up, the government announced a completely new tax project:

a) a 1.5 per cent Net Property Tax on assets worth more than US$50,000, valid during 2004

b) a 0.3 per cent Financial Transactions Tax on current and savings accounts in national or foreign currency, valid for two years (*La Razón*, 2.2.2004)

The Net Property Tax tax was to be a one-off tax charged on all houses, cars, holdings of shares and bonds; any private debts were to be deducted and only if the difference exceeded US$50,000 the 1.5 per cent would apply. According to Rosa Talavera, tax analyst of *PriceWaterhouseCoopers*, the government had a dual agenda with this tax:

"The Net Property Tax was a tax with a double intention: the first was to collect something in order to alleviate the deficit; the second was to give the message that the problems would be resolved by taking into account the variable of equity." (Talavera, interview, 20.5.2004)

Indeed, in his discourse President Mesa repeatedly stressed his aim of charging only those with high levels of income and to leave the poor unaffected (*El Diario*, 15.3.2004). As regards the Financial Transactions Tax (FTT), 0.3 per cent was to be charged on any transaction carried out on current and savings accounts – be they held in dollars or bolivianos. Among economists a tax on financial transactions is usually greeted with little enthusiasm as it is considered to cause disintermediation in the banking system: people would avoid the tax by circumventing bank transfers, and in consequence collection of this tax would gradually decrease. The multilateral financial organisations generally reject any type of tax on financial transactions due to their distortionary effects. It therefore appears that external actors had no influence on the introduction of this reform.[107] Former Minister of Finance, Fernando Candía, commented on the reasons why this tax was nevertheless introduced:

"In general it is a tax that is technically much discredited in the world... There are few places where the tax has worked. Thus, it has been a desperate measure given one could not charge anything else." (Candía, interview, 6.5.2004)

Candía referred to experiences of other, mainly Latin American, countries with this tax. In Ecuador for example a tax on financial transactions was introduced in 1998 and

[107] A document published by the IMF in 2001 summarised its position on this issue: "Bank debit taxes are not in principle an *efficient* source of revenue. Moreover, use of bank debit taxes as a long-term tool risks significant domestic disintermediation, which could be difficult to reverse even if and when the bank debit tax is revoked. In addition, the true cost of their introduction may be underestimated, particularly regarding their adverse impact on the yield of other major taxes if economic activity is driven underground. Finally, the incidence of these taxes is not transparent. The overall policy conclusion is that the use of these taxes should be avoided." (Coelho et al., 2001:24). See also Singh et al., 2005:71.

lasted for less than two years. There it was also introduced at a time when the government was desperate to achieve higher income but where other tax measures were simply unrealistic in political terms. Similarly, in this case in Bolivia: practically all other tax options – for example anything relating to income tax or increasing the VAT rate – had extremely low chances of being approved by Congress and would most likely trigger massive street protests. The government of Mesa thus chose these two taxes in the absence of any possible alternatives, as was also pointed out by Gray-Molina, head of the governmental think tank UDAPE at that time. He also reported that Mesa himself considered the FTT to be a *"terrible tax"* and that he chose it for pragmatic reasons (Gray-Molina, interview, 7.5.2004). The government hoped to raise US$35 million in additional income with the Net Property Tax and US$100 million by the FTT (*El Diario*, 20.2.2004). The executive sent the formalised proposal to the Congress in early February.

Opposition of Santa Cruz's private sector. While several sectors and particularly various business organisations criticised the proposed tax measures, the Santa Cruz based CAINCO, was the most outspoken. It rejected both taxes as it thought they would have a recessive impact on the economy. According to their analysis the Net Property Tax represented a double taxation as it would be charged on assets which were already subject to other taxes. As regards the FTT, the private sector organisation expected that people would withdraw their money from the financial system (*El Deber*, 3.2.2004; *El Nuevo Día*, 17.2.2004). CAINCO and other organisations lobbied particularly heavily against the introduction of the tax on property and in meetings with representatives of the government tried to convince them of the negative effects the tax would have. At first, however, their attempts were of no avail. CAINCO and other organisations from Santa Cruz then sharpened their discourse against the new taxes and in early March announced they would refuse to pay the Net Property Tax should it be introduced. They also called on all Santa Cruz-based legislators to vote against the bill. Responding to this pressure, President Mesa decided to withdraw the proposed property tax and subsequently sent a new bill to the Congress (*El Nuevo Día*, 5.3.2004). The tax withdrawal is widely accepted to have been a result of private sector pressure from Santa Cruz. Gonzalo Vidaurre, economic analyst of the Chamber of Industry, gave details:

"The trend, let's say, for not approving the Net Property Tax started in the sector of the East, exclusively of CAINCO. CAINCO has a rigid position regarding this in the sense that there are large concentrations of land, large concentrations of cattle, and the

entrepreneurs have rather large assets... The failure of this tax, or to take a step backwards, of the government, arises exclusively from the strong opposition of the private sector in the East, of CAINCO." (Vidaurre, interview, 28.5.2004)

Second bill. In the new bill the Net Property Tax was replaced by a complementary tax on property and vehicles and some modifications were made to the FTT:

a) A Complementary Property and Vehicles Tax: owners of houses worth more than US$50,000 to pay 1.5 per cent, one-off tax only valid in 2004; owners of vehicles to pay twice the amount they were charged in 2003, only valid in 2004;

b) FTT: 0.2 per cent, accounts in national currency excluded.

This provision, according to former Central Bank President Méndez, had the objective of helping to reduce the level of dollarisation of the banking system and strengthen the national currency (Méndez, interview, 7.5.2004). The government's calculations anticipated US$35 million from the complementary property and vehicle tax plus around US$70 million from the FTT (per year), which would help lowering the expected fiscal deficit of US$700 million (or 7.9 per cent of GDP) (*El Diario*, 12.3.2004). Though the executive modified its proposal to appease its critics, the opposition to the tax measures continued also after the presentation of this second bill. Financial experts pointed out that the planned complementary tax on property was unconstitutional as it violated tax norms since it represented double taxation: the tax was already charged at municipal level (*El Diario*, 8.3.2004; Villegas, interview, 28.5.2004). Private sector groups argued in a similar way and the CEPB, CAINCO and other business organisations now jointly rejected the new bill. Bolivia's main trade union, the COB, held protest marches where the "double taxation" plans of the government were denounced; and the federation of municipalities held talks with the government to convince it to change its plans particularly regarding the property tax. Finally, within the Congress it was only the MNR who supported the executive in its policy proposal; the other parties opposed them. Both MAS and NFR made an alternative proposal, which was to increase the royalties paid by the petrol sector to 50 per cent (*La Razón*, 8.4.2004). Santos Ramirez, head of the economic team of the MAS, commented on their proposal for lowering the fiscal deficit:

"*Let us put a higher royalty, not a tax, a higher royalty on the petrol companies, in particular those that are exploiting non-renewable resources, gas and oil in Bolivia's case.*" (Santos Ramirez, interview, 31.5.2004)

The suggestion, however, was not taken up by the government or any of the other parties as it was considered unrealistic. Facing criticism from various sectors and the clear absence of sufficient political support for the measure within Congress, President Mesa withdrew the Complementary Property and Vehicle Tax in early March. Therefore only the Financial Transactions Tax remained to be discussed by the Congress and in this case it first went to the Senate.[108] On the 11th of March the upper chamber rejected the FTT (*El Diario*, 12.3.2004), which represented a heavy blow to the government of Mesa. In a televised message he heavily criticised the decision of the Senate and pointed out that he chose taxes that would only affect the rich and that these measures where necessary to lower the fiscal deficit. *"I will not be able to govern without the Congress"*, declared Mesa and he appealed to the legislature to back his measures (*El Diario*, 15.3.2004). This appeal worked and the bill on the FTT was reconsidered by the Senate (which is possible if someone asks for reconsideration of a bill and two-thirds of the Senate back the proposal). A few days later the Senate approved the FTT and the bill was sent to the lower chamber (*El Nuevo Día*, 22.3.2004).

FTT approved by Congress. Though the MAS and the NFR maintained their opposition to the tax measures, the bill seemed set to be approved after the MNR and the MIR had declared they would vote in favour. The two parties were close to holding a majority as they held 62 out of the 130 seats in total, which made a favourable outcome likely. In this moment the Minister of Sustainable Development, Xavier Nogales, declared that all parties except the MAS had promised their support for the tax measure – but only in return for public administration positions (*El Deber*, 26.3.2004). Not surprisingly, denial and outcry was the reaction of the accused parties and the discussion of the bill was brought to a hold. The congressional parties started to prepare for an interpellation of Nogales instead and the approval of the FTT seemed uncertain. Nogales was forced by President Mesa to withdraw his statement and make a public apology. In an unexpected turn of events, during the interpellation an explosion occurred in the Congress: a miner – in an act to protest against the government and asking to have his pension payments returned by the state and given to the widow of his brother – blew himself up with dynamite he carried on his body. With him two policemen were killed, several people were injured and part of the Congress building was severely damaged (*La Prensa*, 31.3.2004). When congressional activity was resumed the legislature decided not to censure Minister Nogales, as a consequence of the tragic events that had occurred – according to President of the Chamber of Deputies Oscar Arrién (*La Razón*, 1.4.2004). Another turnaround happened as the MAS – which

[108] Though unusual it is possible that bills are first discussed in the Senate and then in the Chamber of Deputies.

had always categorically rejected the FTT – announced it would back the tax bill of the executive. While they still did not agree with the measure as such they explained their move by their wish to improve governability (*La Razón*, 1.4.2004). With the votes of MNR, MIR, and MAS the Financial Transactions Tax was approved by the Chamber of Deputies on the 30th of March.

Summary. The FTT underwent some changes in the course of its discussion within the Congress and ultimately the following version was approved: the FTT was set to be 0.3 per cent during the first year of its two-year existence, and 0.25 per cent in the second. Accounts holding less than US$1,000 and any accounts in bolivianos were exempt from the tax (*Ley* 2646, 1.4.2004). While the government hoped to introduce the tax as soon as possible significant delays occurred given that the banks found introducing the administrative procedures more complicated than anticipated. On 1 July, 2004 the FTT was launched and during the first five months the Internal Revenue Service collected US$35 million by way of this tax (*La Razón*, 1.1.2005).

Table 5.5: Stages of Introducing a Tax Reform, 2004*

Original Proposal (1 February)	**Revised Proposal** (4 March)	**Approved by Congress** (30 March)
a) 0.3% Financial Transactions Tax (FTT)	a) 0.2% FTT	a) 0.3% (0.25%) FTT
b) 1.5% Net Property Tax	b) Withdrawn	
	c) Property and Vehicle Tax	c) Withdrawn

Source: Own elaboration. ** Includes proposals formally sent to Congress only.*

To summarise the process: after the first proposal for introducing a FTT and a Net Property Tax were sent to Congress, the latter was withdrawn by the executive facing great opposition from Santa Cruz-based private sector organisations. In the second official proposal the government came up with a third tax: one on property and vehicles. This was heavily rejected by private sector organisations nationwide (though particularly in La Paz where the tax would have had most incidence) but also by opposition parties in Congress and the wider society. After a while the government withdrew this tax as well. In a third stage the last remaining project, the FTT, suffered some significant modifications but was accepted.

Explaining the Fate of Mesa's Tax Bill. There was a significant difference between the government's original proposals and what was ultimately approved. Several times the executive had to withdraw its plans, in the end only one of the three taxes suggested was introduced, and even this one had undergone some significant changes in Congress. Given that the opposition to the FTT was also widespread – though it was not as heavily rejected as the other two taxes – one might wonder why the legislature accepted it at all. The prominent economist Francisco Muñoz (previously PriceWaterhouseCoopers) evaluated this result as follows:

"The Parliament could not reject the two projects as it would have been like saying 'look, I would like you to leave'. Because, you sent me one law, I don't approve it, you send me another one and I don't approve it either, and what is the government going to do, how shall it pay the salaries of the state at the end of the month? So there was no other option than to approve one of the two." (Muñoz, interview, 11.5.2004)

Muñoz thus considered the approval of the FTT as the minimal outcome – anything else would have equalled an attempt to question the government's mandate. While this helps explain why the project was not fully rejected, looking at the counter-question – why such a large part of the project failed – seems at least as important. Part of the problem was that the government's proposals contained elements which were not very carefully thought through. The Complementary Tax on Property and Vehicles could be seen as unconstitutional given that this tax was already charged at municipal level, and so the government was forced to withdraw this proposal. Political analyst Napoleón Pacheco considered that these measures were formulated very quickly under time pressure and without the usual rigorous analysis, which led to errors (Pacheco, interview, 5.5.2004). Weaknesses in the design of the tax bills can thus in part explain why parts of it had to be withdrawn and parts of it were considerably changed.

To explain further why President Mesa encountered such difficulties and why the reform attempt ultimately resulted in a failure one has to look at the nature of his government. The tax measures could simply not be introduced as Mesa did not have sufficient partisan support in Congress. Salvador R. Ballivian of the National Electoral Court made the following observation:

*"This new government which does not have – I won't say it has no majority in the Parliament – it simply has no faction and this has created a situation which obviously has no antecedents in the Bolivian democracy... This is a President who has no faction and where from the start the parties are neither in favour, nor against, but every project of a law makes them say 'this one yes, this one no, this one yes' – it is something very strange for Bolivia. We really are in a universe which we haven't known in the Parliament because previously the so-called "rodillo parlamentario" (*parliamentary rolling pin, SL*) has worked, which was actually the strict imposition of the government's majority. So if the government said this is the project, the so-called*

"rodillo parlamentario" approved it because they had the majority in the Parliament and that was the end of the story." (Ballivian, interview, 28.4.2004)

As Ballivian's statement makes clear the situation was really unprecedented. President Mesa was a political independent who tried to govern without the backing of any political party represented in Congress. It was during the attempt to introduce changes to the tax system that it was demonstrated how difficult it was for the President to govern in this way. It seems he had hoped that the high popularity he enjoyed within society would help him to introduce policies he deemed adequate. When it came to introducing this first major economic policy, however, it became clear that positive public opinion did not automatically translate into the support of the parties represented in Congress whose votes were required for introducing legislation. The tax reform of 2004 failed because of the absence of a coalition in Congress which would have supported the President's initiative. Being without a coalition not only meant that the majority of parties strongly challenged the proposal and did not give their votes, it also meant that no one publicly defended the project making the executive more vulnerable to pressure from private sector groups. Mesa's attempt also has to be seen in the context of a recent failure to introduce an income tax and that there was now a history of successful public opposition to tax reform. In this situation the choice of measures that would be socially acceptable was limited and implementing any changes to taxation would have been difficult for any government.

End of Mesa's Government. As Mesa's term went on, governing became increasingly difficult as he found his legislative initiatives blocked in Congress and at the same time faced growing levels of street protests. In March 2005 he offered to resign – partly in an attempt to force the Congress into approving the earlier mentioned hydrocarbons bill. The legislature refused to accept his resignation. In May 2005 the Congress passed the hydrocarbons law with considerable modifications to the original proposal of the executive: a 32 per cent Complementary Tax on the Hydrocarbons Sector was introduced but in contrast to Mesa's proposal this tax was non-deductible (meaning that companies would pay other taxes like the corporate tax on top of this) and would not be introduced incrementally but in one go.[109] While this went much further than Mesa's proposal and was immediately rejected by the private sector, this legislation did not go far enough for the MAS and a large number of social movements. Their proposal was to

[109] The new legislation also established, for example, that companies had to change their contracts; that prices and sales would be controlled by the state; that 85 per cent of their personnel had to be Bolivians.

nationalise the hydrocarbons sector and to convene a constituent assembly to rewrite the country's Constitution. After the bill was passed street protests intensified and for around three weeks Bolivia was paralysed. Facing a situation of a deadlock, President Mesa again offered to resign on the 6th of June, which was accepted by Congress a few days later. After the next two officials in the line of succession waived their claim to the presidency, the head of the Supreme Court, Eduardo Rodríguez, was appointed on the 9th of June. He considers himself as a caretaker President and new elections are now planned to take place in December. Though street protests have largely stopped for the moment, the next Bolivian president will be confronted with two difficult challenges: demands for the nationalisation of the hydrocarbons sector, and demands for regional autonomy of Santa Cruz.

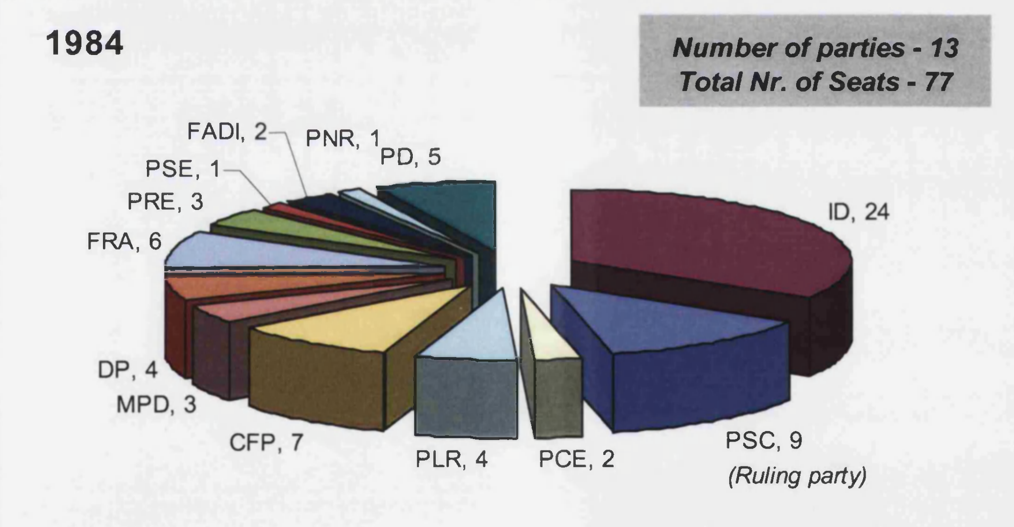
Conclusion. While the pattern of coalition politics still facilitated the introduction of tax legislation during the Banzer-Quiroga government, economic policy-making became increasingly difficult. Though the increase of excise taxes was approved by Congress without any major problems, the President withdrew the new legislation several months later. This policy reversal was most likely because the ruling coalition had been greatly weakened by 2000 (as some coalition partners had left). In consequence, the thus weakened government was more vulnerable to pressure from the private sector which had lobbied for reversing the tax increase ever since its introduction. In February 2003, however, the proposal to introduce a Personal Income Tax failed already before it reached the institutional space of the Congress. A combination of factors proved explosive and a civil uprising – for which the police mutiny proved to be the catalyst – occurred in the course of which the President was forced to withdraw his plans for an income tax. Clearly, it is extra-institutional aspects that account for why this reform failed. An explanation for why coalitions politics collapsed and why the pattern of tax policy-making changed in Bolivia will be sought in Chapter 8.4. In 2004 the tax reform undertaken by Mesa largely failed because of the absence of a coalition in Congress which would have supported the President's initiative. Apart from the dynamics in Congress, business groups had some influence as they managed to make the government withdraw part of the bill. In 2004 no significant societal protest occurred as the taxes proposed did not seem to affect the popular sectors. In fact, the reason why these particular taxes were chosen by Mesa was to prevent the kind of protest that had led to the failure of the 2003 reform. External actors played a limited role in the cases of tax reforms analysed in this chapter: in 2003, though the IMF had made it a condition to lower the fiscal deficit, no specific proposal was made and the decision to introduce an income tax was domestically produced; the 2004 reform introducing an FTT was chosen due to political considerations and the FTT is generally rejected by the multilateral agencies.

6 Ecuador: From Febres Cordero to Bucaram (1984-1997) – The Politics of Tax Reform

6.1 The Government of Febres Cordero (1984-1988): a Tax Reform by Default

In 1984 León Febres Cordero of the right-wing *Partido Social Cristiano* (PSC) came to power: though his principal opponent had won a plurality in the first round, Febres Cordero managed to overtake him in the second where he won 51.5 per cent of the votes, while Borja received 48.5 per cent. His party, however, did less well in the elections to Congress as it achieved only nine seats, whereas Borja's centre-left *Izquierda Democrática* (ID) represented the largest party in the legislature as they had 24 seats (Data from *Tribunal Supremo Electoral, TSE*).[110] The Congress was highly fragmented with 13 parties represented in it, thus making the formation of alliances extremely difficult.

Figure 6.1: Composition of Congress 1984, Ecuador



Source: Own elaboration. Data from TSE.

Febres Cordero was a businessman from Guayaquil who had worked as the chairperson of the Chamber of Industry based there. He was known as a committed neoliberal who considered unregulated markets as the most efficient way to achieve economic development. Febres Cordero ran the first round of his electoral campaign along this

[110] For some background information on the PSC, the ID and other parties see Appendix F.

ideological line and announced he would reduce the power of the state, cut government spending, and support private sector initiatives. As he lost the first round to Borja of the left-wing *Izquierda Democratica* (ID), however, he undertook a U-turn in his electoral campaign. Using the slogan *"Pan, techo y empleo"* (Bread, shelter, and jobs) he promised to raise basic salaries, to implement a housing scheme, and guaranteed that there would be no dismissals from government agencies (Lynch, 1994b:85ff). In the course of his government his policy record turned out to be rather mixed: while implementing market-oriented policies during the first half of his government, he withdrew from these during the second half. Shortly after his inauguration Febres Cordero announced a devaluation of the sucre, limited the minimum wage, eliminated all but a few price controls and increased petrol prices by 70 per cent. In the subsequent years Febres Cordero also introduced more wide-ranging structural changes such as steps towards trade liberalisation, removing export subsidies and reducing import tariffs. Meanwhile, due to falling petroleum prices in 1986 and an earthquake (bringing oil exports to a standstill) in early 1987 the economic situation deteriorated. Facing this situation Febres Cordero sharply cut subsidies, thus effectively raising fuel prices by 80 per cent and public transport costs by 25 per cent. During 1987, however, Febres Cordero backed off from his previous policies, increased public sector salaries, imposed import restrictions and replaced the floating exchange rate – which he himself had introduced earlier – by a fixed one.

Tax reform.[111] During the period of Febres Cordero's government (1984-88), which is usually considered to have made great efforts to introduce radical changes in the economic system, no attempts to overhaul the tax systems were made. One significant change, however, was introduced: in 1986 the Sales Tax – established in 1970 – was increased from 6 to 10 per cent. The Sales Tax (also known as turnover tax) was the forerunner of the VAT (see definition in Chapter 3.2). Raising this tax has traditionally been extremely difficult in Ecuador, since the mid-1980s almost every government has tried to increase its rate and apart from this occasion in 1986 and in 1998, the attempts always failed. Why, then, was it possible for President Febres Cordero – who faced an opposition-controlled legislature – to introduce an increase by four points in the Sales Tax? The finance minister in charge of this bill, Francisco Swett, maintained:

"Febres Cordero had a closed opposition in the Congress, but if you know President Febres Cordero, you know that it is a man who does not fear confrontation and he is a

[111] See Appendix G for an overview of Ecuador's tax system between 1984-2001.

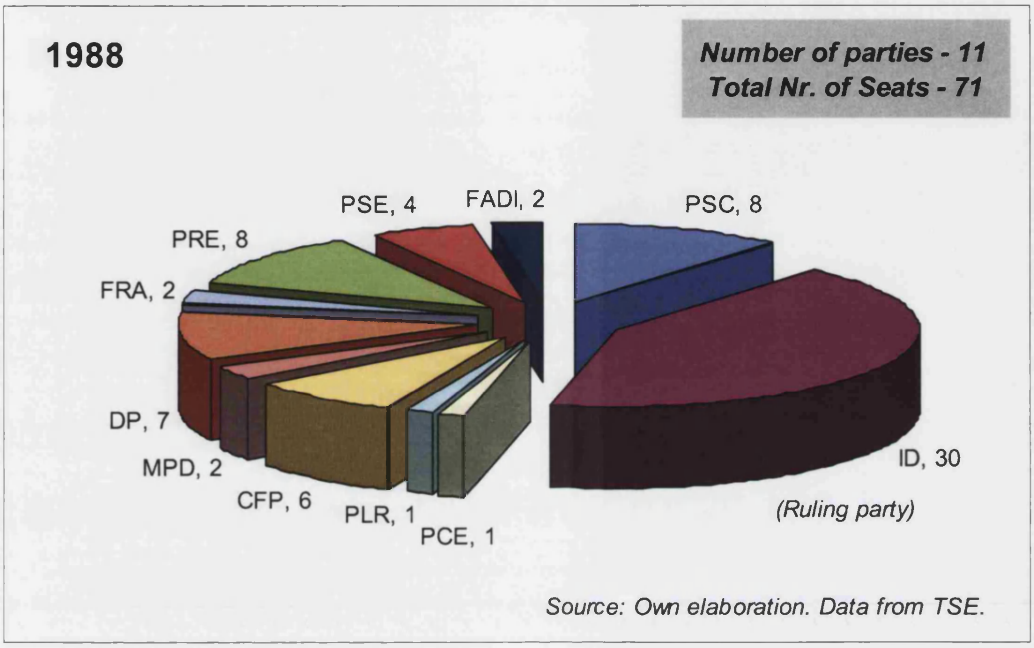
politician of force. And at that time he had at his constitutional discretion to declare an economic law as urgent and the National Congress had, if I remember correctly, 15 days to approve the project. Therefore what the executive did was to send all these projects within one clause of projects and this way he was able to embroil the Congress into a problem of an internal political discussion, which allowed that these measures got through." (Swett, interview, 15.4.2004)

The bill that Febres Cordero had sent contained a large number of economic reforms, one of which was this increase of the Sales Tax. To send more projects than a legislature can possibly deal with within 15 days was a strategy employed by this President rather often. In this case the Congress did not even once discuss this tax reform as they did not have the time. In consequence, the change was introduced by default, *"por ministerio de la ley"*, as it is called in Ecuador. Finance Minister Swett expressed that it was this institutional mechanism – allowing the President to send an economic law as urgent which could contain more than one project – that made the introduction of the Sales Tax increase possible. This constitutional provision became discredited during the government of Febres Cordero, so that his successors did not take recourse to it (and while continuing to send bills as urgent, did not send such a large number of projects at a time). Later on the Constitution was changed to prevent this procedure formally (see Chapter 2.2). Since no other changes were introduced, at the end of the Febres Cordero government the tax system still featured a large number of different taxes and very high tax levels.

6.2 Ecuador's Tax System Reformed: The Government of Borja (1988-1992)

With the election of Rodrigo Borja in 1988 a politician from the *social democratic Izquierda Democrática* (ID) came to power and succeeded the government of Febres Cordero. His election campaign largely circulated around distancing himself from Febres Cordero: he criticised the anti-party discourse and defended the political system, attacking free-market economic policies and the adjustment measures introduced by Febres Cordero (Freidenberg, 2001:320). He repeatedly stated that there would be no surprise fiscal adjustments, in contrast to previous practice. Coming to power, however, Borja inherited a huge fiscal deficit, a fast accelerating inflation rate and a high debt burden. Alongside the announcement of a devaluation and an increase in electricity and energy rates he also raised the minimum wage substantially thus showing his commitment to a more heterodox approach than that of his predecessor. While essentially focusing on stabilisation efforts, Borja also initiated some wider-ranging structural adjustment policies – including further trade liberalisation and a tax reform. In general, however, Borja is often considered to have failed to deliver the effective social reform which his ideology had promised during his presidency. (Carriére, 2001:142).

Figure 6.2: Composition of Congress 1988, Ecuador



First part: 1988-90. Borja's governing party – the ID – achieved an exceptional number of seats in Congress in the 1988 elections: 30 out of 71, or 42.3 per cent. This represented the highest number a ruling party has achieved in the last twenty years and none has ever come close to this result since.[112] The ID was thus little short of a majority. Mathematically, it was possible in this situation to form a coalition with only one other party apart from the ruling ID to hold a majority in Congress. Between 1984 and 2004 the possibility to form a majority coalition with two parties was only given two times: between 1988 and 1990 and between 1996 and 1998. In all other two-year congressional periods (four-year ones since 1998) at least three parties were needed to form a majority.

Coalition with the DP. Soon after Rodrigo Borja took up the presidency he was able to form a coalition with the centre to centre-left *Democracia Popular* (DP), the party of Ex-President Osvaldo Hurtado (1981-84). At first more of an agreement of collaboration with the government, this coalition became more formalised by a parliamentary agreement established on 27 May, 1989. With this agreement DP

[112] The second-highest result was achieved by Mahuad's *Democracia Popular* (DP) in 1998, which won 28 per cent of all seats in Congress.

members were appointed to ministerial and other positions in the public sector. Together the DP and ID mustered a majority in Congress, counting on 37 out of 71 seats in total. Given that also the FADI (*Frente Amplio de Izquierda*) supported the government and belonged to the coalition, it could rely on a rather comfortable majority (39 out of 71). This coalition is often considered as the only "real" coalition Ecuador ever had since its return to democracy. However, it seems that this co-operation was not considered as a coalition by its protagonists and that it was problematic right from the beginning. The leader of the parliamentary bloc of the DP, Patricio Vivanco, described the ID-DP relation as an *"acuerdo politico"* (political agreement) that did not really function as a coalition (Vivanco, interview, 1.4.2004). When asked if he would consider this a governmental coalition, former President Borja answered in an interview:

"It was an agreement at parliamentary level which did not work out very well because many of the government's initiatives were not accepted and processed by the DP. People often say with certain thoughtlessness that I had a majority in the first two years of my government. This is partially true because effectively we had come to an agreement but this agreement was not kept because the DP disagreed with many reform projects which the government wanted to achieve... For every parliamentary initiative we had to open negotiations with this party (DP, SL)*."* (Borja, interview, 24.3.2004)

It is often considered that this coalition lasted for two years until the intermediary elections of 1990. However, the coalition came to an end already in November 1989. The DP announced it would leave the alliance and started withdrawing its members from the previously allocated positions. While there had been an internal division about this collaboration within the DP from the beginning, the opposition faction now seemed to have gained the upper hand. One of the principal opponents to co-operation with the government was former President Osvaldo Hurtado who considered it an *"historical mistake"* (cited by Vivanco, interview, 1.4.2004). Though the party gave programmatic disagreements as a reason for leaving the coalition, it seems certain that the upcoming mid-term elections of 1990 provided an incentive to defect as the DP did not want to reduce its electoral chances by being associated with government.

The above-mentioned failure to introduce the social policies announced in Borja's electoral campaign is also due to the government's lack of coalition partners. When it came to voting on social policies, smaller left-wing parties did not decide on ideological grounds but voted with the predominantly conservative opposition (Biles, 1998:231).

1989 Reform

When in 1988 Rodrigo Borja was elected as President, he took a political decision to make tax reform a major focus of his presidency right on coming to power. In a first phase a tax reform was put forward which would simplify tax collection. Efficiency of collection was to be increased by simplifying paperwork and by establishing new collection locations; at the same time higher penalties for tax evasion were introduced. The reform was mainly administrative and contained few controversial suggestions so that the *Ley de Control Tributario y Financiero* (Tax and Financial Control Law) was approved by Congress without any major discussion in December 1988.

Consultation with society. For the second phase which was to completely restructure the current tax system, a special commission was set up. Finance Minister Jorge Gallardo appointed Carlos Sandoval to chair the Tax Commission and gave them the task to develop a reform proposal. Apart from Sandoval this Commission consisted of various officials of the Finance Ministry, for example the Director of the tax authority (*Dirección General de Impuestos Internos*)[113], who worked together with some foreign consultants (mainly from Colombia, but also Spain and Bolivia). By late July the commission had developed a proposal, which finance minister Gallardo sent to President Borja, who then publicised it to start a process of discussion and public consultation. According to Gallardo himself the rationale behind this procedure was the following:

"The reform had to be discussed so that it would be accepted by civil society, we could not impose it from above, because then, in practice, it would have been rejected." (Gallardo, 1995:37)

In order to facilitate the debate the Tax Commission had elaborated a publication containing the proposal for the tax reform, which was widely distributed throughout the whole country. Thousands of copies were handed out to universities, colleges, various chambers of commerce and industry, workers, teachers, businesses, the media, the Congress, the Supreme Court of Justice, and other public and private institutions. After the proposal for tax reform had thus been spread people had the possibility to hand in comments and criticism to the government for a period of 60 days until the 30th of September, 1989. Carlos Sandoval, adviser to Gallardo and head of the Tax Commission described this process:

[113] At this moment the tax authority was a department of the Finance Ministry (called the *Dirección General de Impuestos Internos, DGII)*, only in 1998 it became an independent body – the *Servicio de Rentas Internas* (Internal Revenue Service, SRI).

"Many people were invited to discuss, business organisations were gathered, also taxpayers, individual people. Big debates were organised in stadiums, open spaces, all over the country. The people came, newspapers reported – even on the taxis they put transfers saying "link yourself to the tax reform, the tax reform benefits us all" etc. – there was a lot of participation. The newspapers dealt with this process for six to eight months. The Minister as well as his advisers, we travelled to all parts of the country talking to people – it was something very participatory, something in which the people got involved." (Sandoval, interview, 26.3.2004)

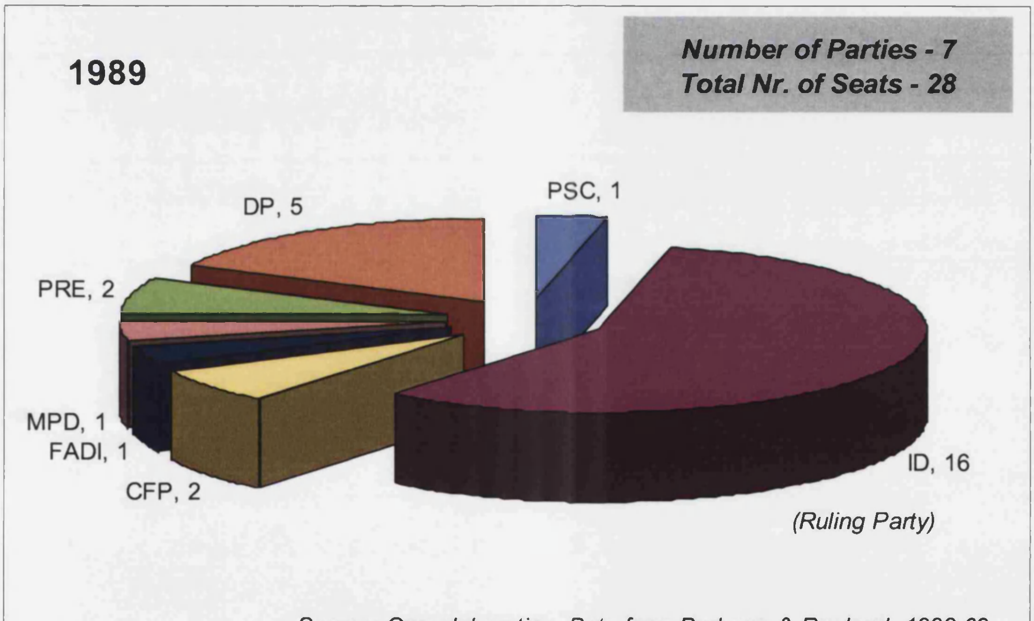
The Tax Reform before the Legislature

After having received these observations the Tax Commission tried to include as many as possible, given they did not contradict the basic principles of the reform proposed originally (Sandoval, interview, 26.3.2004). The modified version was then put to the consideration of President Borja and some further time for debate was given. After several weeks of revising, Borja finally sent the tax reform as an urgent economic reform law to Congress on the 4^{th} of December. Having been sent labelled as "urgent", the Congress was obliged to discuss, approve or reject this proposal within 15 days. Failing to do so within this time period would have made the law come into effect automatically *(por ministerio de la ley)*.

Opposition to the "urgent" character of the reform proposal. The government received a lot of criticism from the other political parties for choosing this procedure, even though it was rather common. PSC, PRE (*Partido Roldosista Ecuatoriana*), DP and FADI (the last two had been in alliance with the government shortly before) joined ranks to argue that a reform of such importance and complexity should not be rushed through and that within 15 days the legislature would not have the possibility to seriously analyse the document. Some even maintained that this procedure would disregard the legislative capacity of the Congress and that the executive had forgotten about the division of powers (*El Comercio*, various issues, 18.11.-10.12.2005). At the forefront of this opposition to the government's decision to send the reform proposal marked as "urgent" was its previous ally – the DP. Patricio Vivanco (DP) voiced his criticism repeatedly and argued that Borja's attitude annulled the legislative capacity of the Congress, given that the Parliament would not be able to analyse the project or add anything to it (*El Comercio*, 5.12.89:3). The DP was the only party which went as far as threatening to not attend the discussion in the legislature if the government would not reverse its decision (and in effect later on did not attend the sessions). In defence to this mounting criticism calling for a withdrawal of the urgent character of the law, President Borja defended this procedure by stating: "*Since when does using a constitutional* *power represent an aggression against the National Congress?"* (*El Comercio*, 4.12.89:1).

The criticism did indeed have no legal basis as the Constitution clearly gives presidents the right to send urgent economic reforms. What does and does not constitute "urgency" has never been clearly defined so that in practice presidents have always sent their economic reform proposals as "urgent" whenever they considered it to be urgent. The opposition was thus merely able to make a moral appeal. They also pointed out that under the previous government it was Borja's ID which heavily attacked Febres Cordero's habit to exploit this procedure. While not being able to stop this process, the discussion made clear that opposition to the government's endeavour did exist. Borja reported that the political parties from the right spectrum opposed the government's proposal for tax reform (Borja, interview, 24.3.2004).

Figure 6.3: Composition of Plenario 1989, Ecuador



Source: Own elaboration. Data from Burbano & Rowland, 1998:62.

Legislative space: the "Plenario". When the tax reform was sent in December, it came at a time when the National Congress did not convene, thus the task of deciding on this bill fell to the *Plenario de las Comisiones Legislativas (Plenario)* (see Chapter 2.4). That the *Plenario* had the power to decide on laws outside the periods during which the full Congress convenes seems to be exclusive to the Ecuadorian political system (abolished in 1998). Another rather striking fact is that only since 1996 did the composition of the *Plenario* need to be proportional to the composition of the Congress (see Chapter 2.4). Consequently, in 1989 this was not a requirement and when comparing the composition of the Congress of 1989 to that of the *Plenario* of the same year, one finds, rather surprisingly, that significant distortions existed. While the ruling party – ID – did not have a majority in the Congress (see Figure 6.3), it did have a clear majority in the *Plenario*. While holding merely 42.3 per cent of the seats in Congress, it had 57.1 per cent in the *Plenario*. In addition, the *Plenario* was much less fragmented than the Congress as only seven parties were represented here, and 11 were part of the Congress.

The reason why the opposition parties so strongly objected to the procedure chosen by the government – to send the tax reform as an urgent economic reform law – now becomes clear. Under these circumstances the law had to be approved within 15 days – thus within the period of sessions of the *Plenario*. Had the proposal been sent without being labelled as "urgent" the discussion of the legislature could have been extended until the full Congress convened again. Given the different distribution of seats and given that the ruling ID was without allies at this moment, the opposition would have been able to make modifications or reject certain proposals in Congress. With its comfortable majority of 16 out of 28 seats in the *Plenario*, however, having this tax reform approved did not require political negotiation. During the last two decades this was the only situation when a single party was able to approve a law purely by counting on its own votes. Timing thus became an important aspect as sending the bill outside the period of the Congress made things much easier for the government of Borja.

Following the usual process, the *Plenario* discussed the proposal in a first debate on the 5th and the 6th of December, after which the Commission for Tax, Fiscal, Banking, and Budget Matters (*Comisión de lo Tributario, Fiscal, Bancario y de Presupuesto*) elaborated a report on the basis of the original proposal and the comments made during the first discussion in the *Plenario*. In the debates that took place between the 12th and 14th of December, the 126 articles of the reform proposal were approved with hardly any modifications. One of the few items that were slightly changed concerned the Special Consumption Tax (*Impuesto a los Consumos Específicos,* also excise tax) where the *Plenario* implemented some minor changes to the rates. On the 22nd of December the changes to the tax system came into force as the law was published in the Official Register (*Ley* 56, 22.12.1989).

Contents of the reform. The changes introduced to the tax system were wide-ranging and until today the 1989 reform is generally held as the most radical tax reform of the last decades. In an interview, Ex-president Borja commented on the aims of the reform:

"The government decided to simplify the tangle of more than a hundred messy, anarchical taxes and consolidate them in three fundamental ones: Income Tax, Value-added Tax, and Special Consumption Tax" (Borja, interview, 24.3.2004).

Accordingly the tax system was greatly simplified and many small taxes which generated little income (or which generated higher administrative costs than income) were abolished. Among the most important changes were the new provisions regarding income tax: the Personal Income Tax, which was previously ranged between 10-50 per cent, was lowered to 10-25 per cent. People earning less than 2.5 times the minimum wage were exempt from paying this tax.[114] The number of tax brackets was reduced from 15 to 4 (10, 15, 20, and 25 per cent). The Corporate Income Tax previously had progressive rates between 0-59 per cent and was now set at 25 per cent. The second main element of this new tax system was a VAT of 10 per cent, which replaced the previous Sales Tax, which had been at the same rate. An excise tax represented the third pillar. Taxes on cigarettes, alcoholic drinks, beer and soft drinks were unified in one piece of legislation under the concept of excise tax with charges ranging from 5-260% (for rates see Appendix G). To target administrative shortcomings of the current tax collection, provisions were taken to facilitate collection by simplifying the bureaucratic procedures: for example additional collection points were established and forms for tax declarations were substantially shortened and simplified. Some changes to the tax code were also introduced and penalties for tax evaders increased substantially.

Table 6.4: Main Elements of 1989 Tax Reform

Tax Reform 1989: Main Elements
Income Tax: 1) Personal Income Tax: 10-25% (previously 10-50%); 2) Corporate Income Tax: 25% (previously 0-59%)
Value-added Tax (VAT): 10%
Special Consumption Tax: 5-260% charges on cigarettes, alcoholic drinks, beer and soft drinks
Penalties for tax evasion increased
Tax Administration: bureaucratic procedures simplified
Source: Own elaboration.

[114] The amounts were adjusted over the years, in 2003 income of up to US$6,800 per year was exempted.

According to Carlos Sandoval, head of the Tax Commission, the reform achieved the following: *"We created a system that was transparent, simple, equitable, and homogeneous – we reduced the tax rates drastically."* (Sandoval, interview, 26.3.2004)

Why the Reform was Possible

Given that the reform of 1989 represents the most comprehensive change introduced to the tax system since Ecuador's return to democracy, and given that introducing tax legislation subsequently often failed, it needs to be asked why this reform was possible and what conditions played a role in making it happen.

Plenario. As outlined earlier it can be argued that a major factor was the institutional aspect of allowing the Congress's substitute – the *Plenario* – to decide on this economic policy, in combination with the fact that the legislation did not require the *Plenario* to be composed proportionally to the Congress. This feature of the political system allowed the reform to be approved basically without any modifications. In line with this argument, when asked why this reform was possible, many of my interview partners named as one of the most important reasons the fact that President Borja had a majority in the legislature (Interviews with Acosta, Better, Corral, Ribadeneira, Ruales, Sandoval, Swett, Valencia).[115]

Awareness of the need for change. Other conditions facilitated the process: for a start, a consensus existed that the tax system was outdated, far too complex and no longer appropriate leading to the accordance that substantial changes were necessary. The prominent Ecuadorian economist and political analyst Alberto Acosta considered:

"There was a very broad awareness in society that the tax structure had become a chaos. It was hugely difficult to understand what was going on so there was a feeling that something had to be done." (Acosta, interview, 23.3.2004)

The discussion process organised by the Borja government to consult the public opinion on the proposed changes to the tax system was outlined earlier. Minister of Finance Gallardo considered this process as "*a democratic experiment which has never before been realised neither in the country nor in Latin America*" (Gallardo 1995:110). It was the only time that a tax reform was processed in this way: since then no other president has chosen to consult society before fixing a reform proposal and sending it to Congress. This consultation process has led to a greater ownership of this tax reform and popular

[115] Some of these assessments may be based on the misperception mentioned by former President Borja earlier, however.

backing of the reform therefore provided a complement to the partisan support President Borja counted on in Congress.

Government campaign. Yet, public opinion was not only convinced of the process chosen by the government to introduce the reform but also largely agreed with its contents. It was widely perceived as being fair and not as aggravating the financial situation of the lower income classes. The government lobbied with the slogan "*who owns more, pays more*", and the discourse used focused very much on the concept of justice, pointing out that this reform would not harm the common citizen in exchange for giving liquidity to the state but was aimed to implement social justice (*El Comercio*, 21.11.89:2). In the weeks before the bill was sent to Congress, the government carried out a big campaign, placing advertisements in the main newspapers: using "*You won't pay taxes!*" as the main headline, people of different professions were informed that if their annual income did not exceed ECS2,000,000 (around US$3800 at that time) they would be exempt from paying income tax. Lobbying with such an apologetic sounding text might seem slightly counterproductive in a country where tax compliance is already quite low, yet the message that low income groups would not be taxed certainly went down well with the people addressed. The advertisement also gave easily understandable and precise information about income tax and who would pay it. The government campaign even used a logo – **R↑** *Reforma Tributaria* (Tax Reform) – a rather unusual move representing an attempt to give a positive image for what is traditionally seen as an unpopular reform. Once the bill was passed in Congress, finance minister Gallardo commented:

"The country walks towards a new process of economic development, a re-orientation of economic resources towards a new model which is more just, fairer, without benefits for the privileged sectors but in a fair and general way just like the Constitution says." (Gallardo, *Congreso Nacional del Ecuador, Acta No.* 21-C)

A socially just reform. Looking at the tax system introduced, it becomes clear that the above is not mere rhetoric. Income tax rates – at least the top rates – were lowered both for Personal and Corporate Income Tax; consequently little opposition could develop from either side. Even though a VAT was introduced, it was to replace the previous Sales Tax set at the same rate of 10 per cent. Few people can be expected to have understood the technicalities of that change (see definition in Chapter 3.2). Pablo Better, Finance Minister during the second part of Borja's government maintained:

*"The lowering of the tax rate was something society accepted, if I have to pay less income tax I will support this project (*is what people thought, SL*) ... There was no resistance in the society."* (Better, interview, 30.3.2004)

At the same time, however, it was clear to everyone that with the overhaul of the tax system a new era would begin and that from now on evading taxes would become a lot more difficult and many people might pay more taxes than before. Acceptance of the reform can therefore not simply be explained by the fact that some taxes were to be lowered. Another factor increasing popular acceptance of this reform was pointed out by tax expert Wilson Ruales. He referred to the first phase of the tax reform in 1988 in which the changes introduced had benefited increased social spending (for example a literacy programme). According to Ruales this set a positive background for the subsequent reform proposal in 1989 (Ruales, interview, 23.3.2004).

External influence. External influence seems to have played a limited role. Multilateral organisations – such as the IMF, the World Bank and the Inter-American Development Bank (IDB) – can be ruled out: tax reform would only become part of their agenda in the 1990s. Sandoval, chairperson of the Tax Commission, affirmed that there had been no pressure whatsoever from any of the multilateral organisations (Sandoval, interview, 26.3.2004). There had, however, been a Latin America wide trend to introduce similar changes. Many other countries had carried out those reforms earlier: introducing a VAT and reducing the top rate of Personal Income Tax, which throughout Latin America fell from 50 per cent to 38 per cent between 1985 and 1991, while Corporate Income Tax was reduced from 43 per cent to 36.5 per cent on average (Shome, 1999:5,8). Chile introduced a major tax reform in 1984, Bolivia in 1986, Colombia in 1986 and Mexico in 1987, to give some examples. The Tax Commission set up to develop the Ecuadorian reform did consult with experts mainly from Colombia (also someone from Bolivia) as their tax reform was considered as a model (Sandoval, interview, 26.3.2004).[116]

Economic interest groups. In the case of the 1989 tax reform private sector groups had some influence even though the modifications they were able to gain from the government were very modest. The issue under attack from economic lobby groups was related to the provision of "adjustment for inflation". The element of "adjustment for inflation" was important at times of high inflation rates. The change aimed at charging on real income rather than monetary income which was much distorted due to high

[116] In fact, Sandoval pointed out that they considered the Colombian reform as a model rather than the Bolivian one as they thought the first was closer to their idea of a socially just tax system (Interview, Sandoval, 26.3.2004).

inflation rates. The business sector heavily opposed this as it would increase their tax burden.[117] In the end the government yielded to some extent to these particular demands: "adjustment for inflation" was introduced only gradually (Sandoval, interview, 26.3.2004). While a compromise was found on this matter, there are some indications for certain tensions between economic interest groups and the government. In an interview in *El Comercio* (9.11.89:1) Marcelo Pallares, President of the Chamber of Commerce of Quito, said it would be better for the government to ask the productive sector to participate in the tax reform commission so as to know their opinion directly, instead of them having to wait for a Pandora's box. Former President Borja mentioned opposition against the reform from the business sector (Borja, interview, 24.3.2004). In his opinion:

"It is a question of political will of a government which does not respond to created interests; of a party which was in power at the time and which had never defended the interests of any pressure group, of any chamber of production. Thus, with this enviable freedom giving independence from privileged economic groups, we were able to do what appeared right to us and impose this decision." (Borja, interview, 24.3.2004)

In Borja's opinion, therefore, his government did not have to deliver the reform to economic interest groups because of their independence of these groups and their political will. While surely every party claims to be independent from pressure groups, the ID's independence and lack of linkage was confirmed by outsiders (Ruales, interview, 23.3.2004). At the same time, however, it has to be kept in mind that some of the main elements of the reform were actually in the interest of the business sector, such as lowering the Corporate Income Tax.

Timing. Finally, timing was another factor conducive to the success of this tax reform. The government worked on this reform project from the beginning, introducing the first part of the reform already some months after coming to power (December 1988). Only one year into the four-year term of the government (and well before the intermediary elections) the second phase was started in late July 1989 and approved in December of that year. According to Carlos Sandoval, the reform thus came before a debilitation of the government, which facilitated its introduction (Sandoval, interview, 26.3.2004).

Effects. Though it is not within the scope of this work to evaluate economic outcomes, the results of the 1989 tax reform need mentioning. Though the government had expected that tax revenue would increase after the implementation of the reform, the

[117] For more information on this issue see Chapter 4 of Gallardo, 1995.

hopes were disappointed as numbers actually fell. While in 1989 tax income was 8.9 per cent of GDP, it fell to 8.0 per cent during both 1990 and 1991 (see Table 6.5).

Especially revenues from income tax decreased from 1.9 per cent of GDP in 1989 to 1.3 per cent in 1990 (Salgado and Santos, 1998:65). The strategy of raising the number of contributors and thus increasing the revenue generated did not work out as apparently the increase in contributors did not make up for the reduced rates.

Table 6.5: Tax Income (% of GDP), Ecuador 1987-92[118]

1987	1988	1989	1990	1991	1992
9.2	8.4	8.9	8.0	8.0	7.5

Source: Own elaboration. Data from BCE.

The Borja Government (1990-92). With the intermediary elections of 1990 the situation of the Borja government changed dramatically and introducing reforms became more difficult. The ruling party had its seats in Congress reduced by more than 50 per cent and with its now 14 seats no longer represented the biggest party; in the *Plenario* the ID had lost its majority and now merely held four seats (down from 16 in 1989). In consequence, gathering a majority for its reform projects became much more difficult for the government. Mejía-Acosta (2000:20) provided some interesting data on this: while the Borja government submitted 40 pieces of legislation between 1988 and 1990 and got 22 (54.7 per cent) of it approved by the Congress; in the 1990-92 period only six out of 29 proposals were approved (21.3 per cent). Ecuador's electoral system, which featured intermediary elections until 1998 thus did split a president's governmental term into two very different periods. Since elections are always a measure of a government's popularity, the 1990 elections showed the hugely reduced support President Borja enjoyed in society. The intermediary elections have allowed this reduced popular support to translate into reduced political support in the legislature, making governing more difficult. While of course in other countries presidents also lose support in the course of their governmental term, the lack of mid-term elections (few countries other than Ecuador had this) does make them largely keep the share of seats the ruling party gained in the first place. While governing might become more difficult during the course of a governmental term everywhere, conditions are more severe in Ecuador as gathering support in the legislative space becomes even more difficult.

[118] The numbers do not include revenues from the oil sector.

Figure 6.6: Composition of Congress 1990, Ecuador

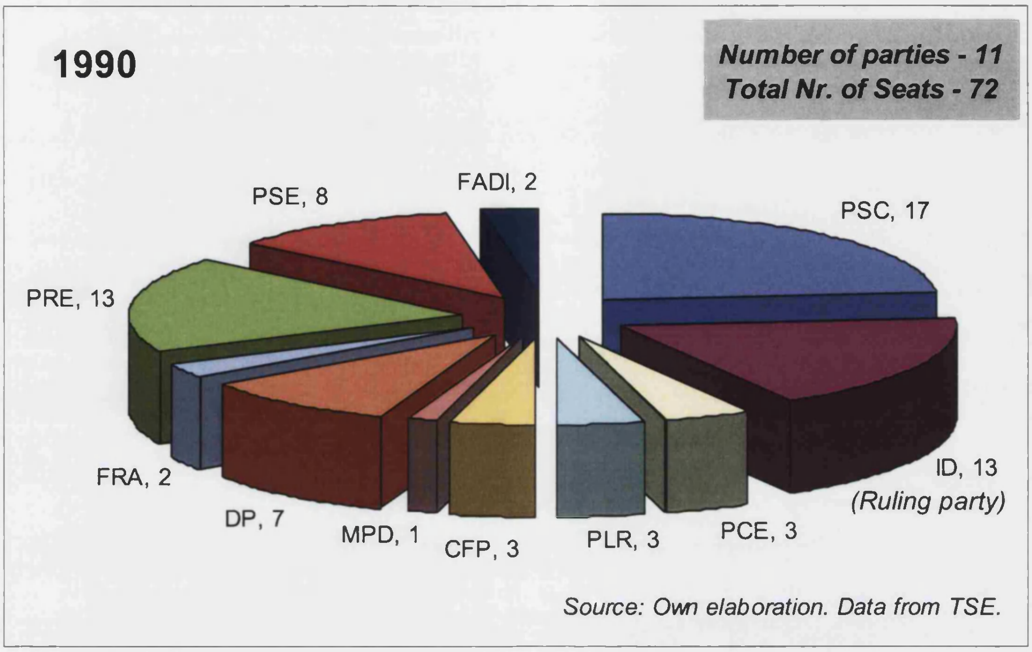
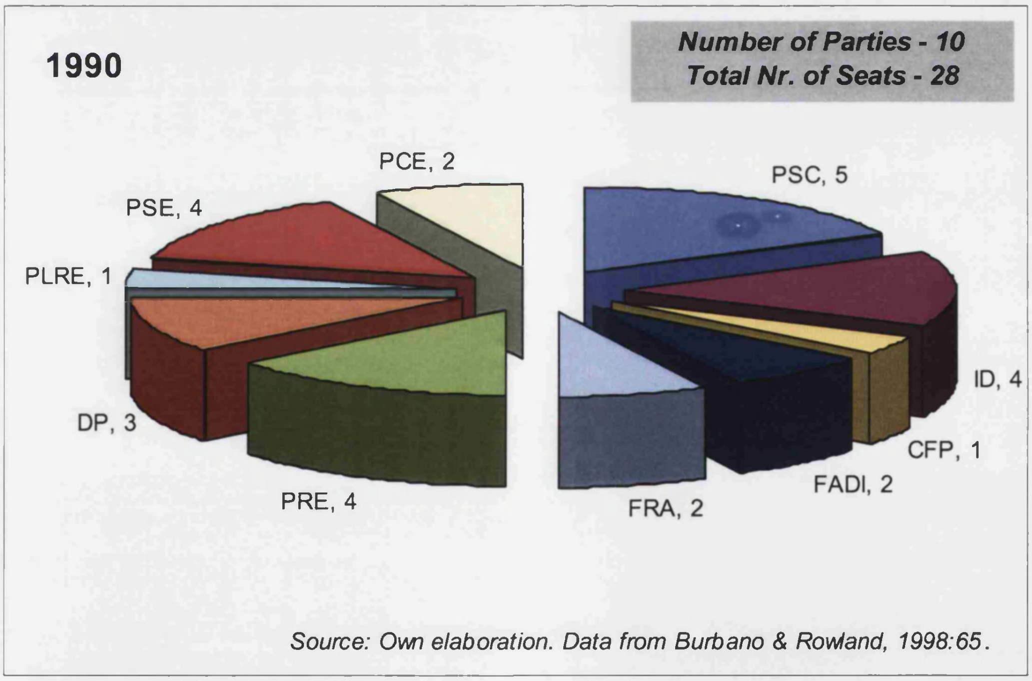


Figure 6.7: Composition of Plenario 1990, Ecuador



Another indicator of the huge obstacles that President Borja's government was facing in the second part of its term is the increased rate of congressional interpellations (see Chapter 2.2) members of Borja's cabinet had to go through. Minister of Agriculture Marcos Espinel, for example, had to appear 28 times in front of Congress to defend himself against censure initiatives in his 24 months in office – a procedure which certainly somewhat distracted him from following policy initiatives (De Janvry et al. 1994:45). Between 1988 and 1992 ten ministers were threatened by Congress with a vote of censure, eight of whom were effectively censured and had to resign (Burbano and Rowland, 1998). All of the removals from office took place in the last two years, thus after the intermediary elections.

Tax reform. The government of President Borja had planned a follow-up phase to the tax reform introduced in 1989. After a VAT had been introduced with that reform, another reform was to eliminate the exonerations from this tax. Yet this subsequent reform was never realised. Pablo Better, finance minister during this period, reported that he was working on a reform proposal but in the end the President did not even send the project to Congress as Borja did not have a majority in the legislature any longer and there was a strong opposition (Better, interview, 30.3.2004). No significant changes to the tax system were thus introduced during the years 1990 to 1992. Pablo Better considered that the planned tax reform

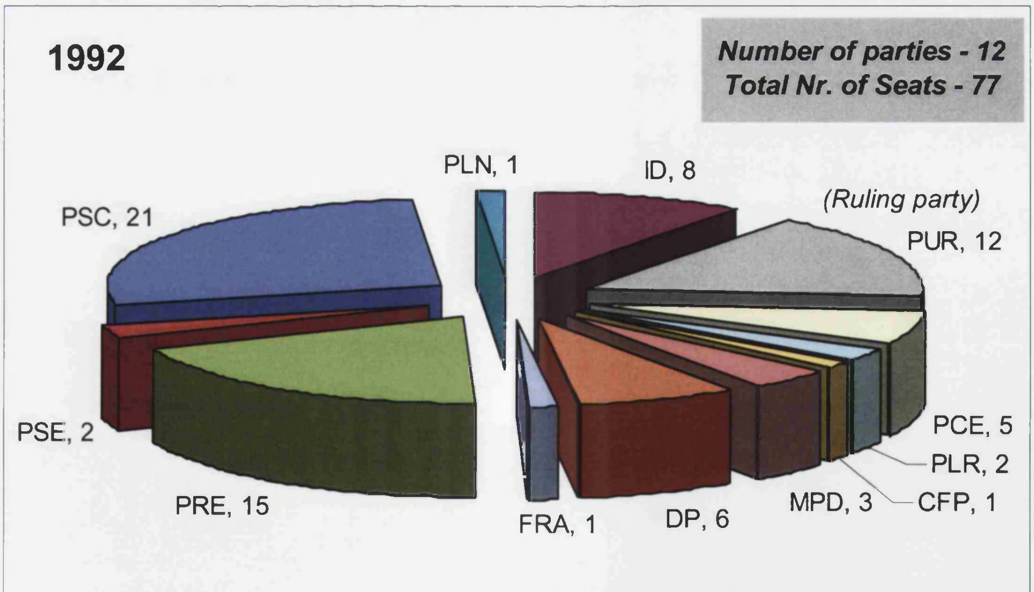
"was not politically viable. In the second half of presidential periods you cannot do anything in Ecuador. You cannot introduce important legislation." (Better, interview, 30.3.2004)

Summary. The reform introduced in 1989 can be considered as the most important change to the tax system during the last decades. Two elements should be stressed: on the one hand there was an extraordinary political situation given that the ruling ID had won such a large share of seats in Congress. Constitutional provisions concerning the *Plenario* allowed President Borja to have the reform approved there, where the ID held a majority and had no need for forming alliances. Complementing this institutional aspect was the popular support brought by a consultation process, an exceptional democratic experiment of involving society in the policy-making process. While these are considered the main reasons for the success of the reform, other factors have played a role. Generally there was awareness – in society and the political parties – that the tax system was outdated, far too complex, and needed some significant changes. As regards the content of the reform, the proposal was mainly accepted as it appeared to be a socially just reform. Opposition was limited since, for example, income tax was actually lowered. External influence only came through the fact that most Latin American countries had already introduced similar changes. Finally, timing was crucial – the reform was introduced in the first part of Borja's government before he lost political support. The situation of Borja's government dramatically changed after the intermediary elections in 1990. His government was effectively split into two very different periods, one during which important legislation was introduced and a second marked by political conflict and little legislative activity and success. The constitutional provision of intermediary elections consequently had a considerable influence on Borja's ability to introduce tax reform, and more generally, to govern.

6.3 Tax Reforms during the Government of Durán Ballén (1992-1996)

In 1992, the conservative politician Sixto Durán Ballén won the presidential election, heading the Republican Union Party (PUR). Durán had been a long-standing member of the PSC and twice its presidential candidate; after the PSC had denied him the presidential candidacy for the 1992 elections, he founded a new party, the PUR, in order to be able to stand. The party, however, did not survive after this governmental period and can thus be considered as an electoral vehicle allowing Durán to gain the presidency. The shortcomings of this approach showed its effect in the composition of the Congress where President Durán's PUR took only 12 out of the total 77 seats, or 15.6 per cent. The Congress was highly fragmented, with none of the parties being able to form a majority without at least two other parties. The PUR represented only the third biggest party in Congress, both the PRE and Durán's previous party PSC held higher numbers of seats.

Figure 6.8: Composition of Congress 1992, Ecuador



Source: Own elaboration. Data from TSE.

President Durán had managed to form a coalition with the *Partido Conservador Ecuatoriano* (PCE), which only held five seats. The ruling coalition of PUR and PCE thus counted on 22 per cent of all seats in Congress. In the *Plenario* the ruling PUR held six out of 28 seats. One year later the situation changed significantly as many legislators disaffiliated from their parties. Disaffiliations – for which Ecuadorians even coined a word "*camisetazos*" (changing shirts) – are a frequent phenomenon in Ecuador. The Constitution does allow disaffiliated members to keep their seat in Parliament, so leaving a party carries no personal consequences. Other Latin American countries provide that legislators have to give up their seat if they disaffiliate from their party, as, for example, in Bolivia (since 1997). During the governmental period from 1992 more and more legislators became independent: the legislators of the CFP, PLN (*Partido Libertad Nacional*) and FRA disaffiliated thus making these parties disappear within Congress completely; the ID lost four of its members, the DP three, the PRE three and the ruling PUR lost two of its legislators. This lack of party discipline exceeded the traditionally already high levels: by August 1993 18 per cent had disaffiliated (see Table 2.4 in Chapter 2.5). The Congress was now even more fragmented and independents represented an important political force.

Economic reform programme. During his election campaign Durán Ballén had campaigned for a return to free-market policies such as privatisation and decentralisation (Roos and van Renterghem, 1997) thus stressing his difference to his predecessor Borja. As another indication of his ideological orientation he had chosen Alberto Dahik, who had served as economy minister under Febres Cordero and who was known as a convinced neoliberal, as the vice-presidential candidate. Yet in the course of the campaign Durán Ballén also shifted to the centre in many of his statements and limited his orthodox discourse to increase his popularity among broader sectors of the population. Once in power, however, his policies were mainly market-oriented in character. One month after coming to power he announced plans to raise the price of petrol by 125 per cent, double electricity rates, and devalue the sucre by 35.5 per cent. In the first half of his term he significantly lowered the fiscal deficit, reduced public sector jobs by around 10 per cent, and deepened trade liberalisation. Some of Durán's more long-term structural policies were not always successful: especially his privatisation plans failed as he faced severe opposition from a large number of interest groups. In addition, his attempt to change the land reform law met with fierce protest of the indigenous movement due to which he had to modify this policy. Many of his structural reform plans also failed due to lack of support for his policies in the opposition-controlled Congress.

Tax Reform 1993

At the end of 1993 a major tax reform was elaborated by the government: a) VAT was to rise from 10 to 18 per cent, b) exemptions to VAT reduced, c) a 1 per cent Tax on Fixed Assets introduced, d) some excise taxes on luxury items raised, and e) a 25 per cent Tax on Stock Market Gains established (see Table 6.9). The government argued that the current economic situation was so severe that a radical tax reform was needed to reduce the fiscal deficit. Vice-president Dahik pointed out that the country had lost ECS1 billion in one year due to the fall of oil prices (*El Comercio*, 17.12.93:6).

Opposition and protest. The opposition to the reform proposal questioned the government's evaluation of the economic situation. Many argued on a similar line to the representative of the banking sector, Alejandro Peñafiel, who questioned the severity of the economic difficulties and who deemed such drastic measures unnecessary given that the problem was of a short-term nature since oil prices would, in his opinion, certainly increase sooner or later (*El Comercio*, 20.12.93:16). The opposition and protest to this reform was widespread and voiced immediately after its announcement. The *Consejo de Cámaras y Asociaciones de la Producción* (Council of Chambers and Associations of Production) sent a letter to the President contesting the reform, specifically opposing the increase of the VAT rate, and pointing out that the Special Consumption Tax should rather be lower than higher (*El Comercio*, 16.12.93:6). Other economic interest groups from both Quito and Guayaquil joined in and criticised the proposal heavily. Protest also came from the popular sectors of society, various trade unions[119] and social movements took to the streets criticising the latest economic policy proposed by the government (*El Comercio*, various issues December 1993). Completing this alliance of opposition, members of the institutional political level spoke out against the reform publicly, as did the Vice-president of the Congress Bruno Frixone. The main arguments were that the suggested policy would have a serious negative effect on the economy and increase unemployment.

Congress rejects reform. The opposition outside the political system was reflected inside it, the great majority of parties had already demonstrated their opposition to the reform and the government failed to mobilise partisan support for this proposal in Congress. Especially the proposal to raise the VAT from 10 to 18 per cent found little or no support. Consequently, most of the plan was rejected and the attempt to reform the

[119] For example, FUT – *Frente Unitario de Trabajadores*; CTE – *Confederación de Trabajadores*; UNE – *Unión Nacional de Educadores.*

tax system failed. As regards the main elements of the reform: a) VAT stayed at the same level; b) exemptions to VAT remained unchanged; c) the 1 per cent Tax on Fixed Assets was rejected; and d) excise taxes were actually lowered rather than increased as originally proposed (see Appendix G). Thus all proposals for increasing or establishing new taxes were turned down, except one: e) a 25 per cent Tax on Stock Market Gains was approved by Congress. However, this new tax faced such strong opposition by business groups who heavily lobbied against it, that the government ultimately conceded and withdrew it in February 1994. Several of its minor articles were approved; however, in general the reform had been deprived of practically all its main elements. The reform can thus be considered as a failure.

Table 6.9: Tax Reform (attempt) 1993 – Main Elements

Original Proposal	Reform Approved
VAT increase from 10 to 18%	Rejected
Reduction of VAT exemptions	Rejected
1% Tax on Fixed Assets	Rejected
Increase of some excise taxes	Some excise taxes lowered
25% Tax on Stock Market Gains	Approved (withdrawn some months later)

Source: Own elaboration.

Former Finance Minister César Robalino commented on this unsuccessful attempt:

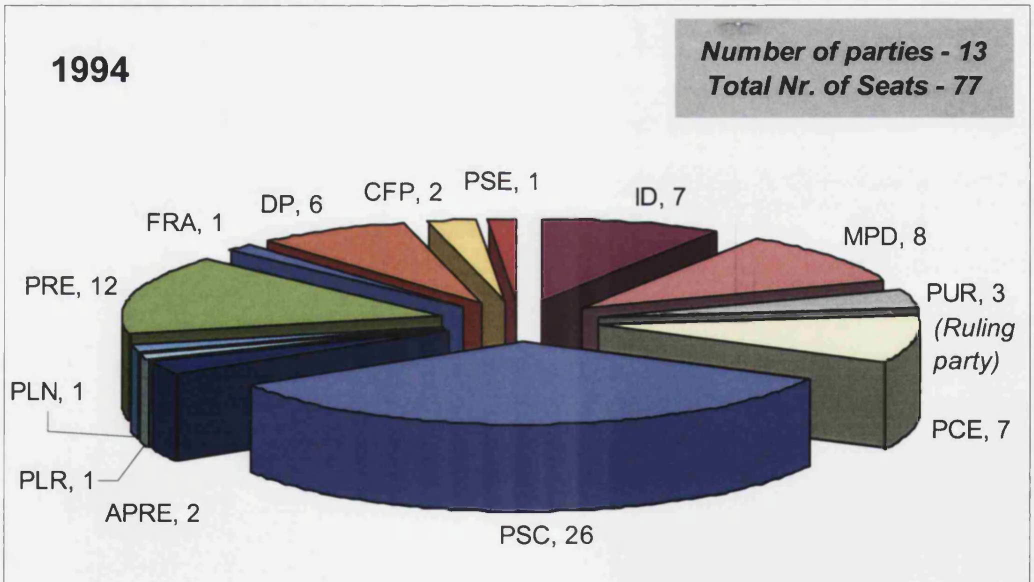
"President Durán and his party had few votes in the Congress, so that the majority of the legislators were not from the government and the government did not really manage to convince. We could not convince, not I as the Finance Minister, nor the Minister of Government, nor the Vice-president who then helped us to make contacts in the Congress. We could not convince the legislators. ... The Congress defeated us, they defeated us completely. The idea was to increase the VAT ... but the Congress decided that under no circumstances any tax could be increased. All political parties united to defeat the proposal to increase taxes and this is not exceptional in Ecuador." (Robalino, interview, 5.4.2004)

Given the failed tax reform and the high fiscal deficit, President Borja soon announced an increase on the price of domestic fuels (by 71-140 per cent) on 28 January, 1994. While a hugely unpopular measure in society, this is a measure for which presidents do not need the approval by Congress as it can simply be decreed. The pattern of a failed tax reform followed by a fuel price increase was very common during the last twenty years.

Why the reform failed. In many respects the tax reform attempted by Durán's government can be considered as the opposite to the reform undertaken in 1989. In 1993 the conditions simply did not allow this reform to go through. President Durán came to power with a ruling party that counted on a very low number of seats in Congress. This base had eroded even further one year later and at the time of this reform endeavour some disaffiliations had occurred. As regards the content of the reform proposal several taxes were to be raised and some new ones introduced. In retrospect one might consider especially the VAT rise to 18 per cent as highly unrealistic and ask how much the creators of this reform took political viability into account when putting it forward. Opposition and protest came from all sides immediately after it had been announced. All sectors of society – economic interest groups, trade unions, social movements – criticised and opposed the reform. In Congress, the reform was outright rejected given the opposition of a great majority of the parties. While sectors of society and Congress facilitated the reform undertaken in 1989, public and congressional opposition led to the failure of the tax reform undertaken in 1993. Extra-institutional and institutional opposition had formed a double veto group.

Mid-term elections - 1994.

Figure 6.10: Composition of Congress 1994, Ecuador



Source: Own elaboration. Data from TSE.

The mid-term elections held in 1994 once again completely altered the political power balance in Congress. The ruling PUR was reduced to a mere three-seat party with six of the other parties holding more seats. Some of the opposition parties managed to increase their share in Parliament: the main opposition party PSC now held 26 seats (previously 21), the left-wing MPD (*Movimiento Popular Democrático*) went up to eight (from three); PUR's coalition partner PCE also gained in the elections and now had seven seats (up from five) which led to the rather unusual situation that the coalition partner was actually bigger than the ruling party itself. Now being one of the smaller parties Durán Ballén's party no longer held any seats at all in the *Plenario*. While the first part of President Durán's government had been relatively stable, the second part between 1994 and 1996 was a period of high political and economic instability. Especially 1995 was a critical year mainly because of the military conflict with Peru. The military intervention, lasting one month in early 1995, aggravated the already tight financial situation of the public sector. According to Salgado and Jácome (1995:58) the direct cost of the military operations (excluding the money spent on buying weapons) were around US$350 million, which represented approximately 2 per cent of that year's GDP. Another destabilising factor was difficulties in the electricity sector, which made energy rationing necessary. While rationing had happened frequently before, it had never reached such serious levels. Between 1995 and 1996 the country underwent more than six months of electricity rationing, which severely limited economic growth in general.

At the political level, legislative-executive conflicts became rather intense. In June 1995 Vice-president Alberto Dahik denounced corruption prevalent in the Congress referring specifically to a case where one party demanded ECS200 billion in exchange for voting in favour of a particular legislation. His accusation obviously referred to the PSC. At the same time accusations against government officials of giving bribes to legislators to buy their votes were widespread. This conflict resulted in the impeachment of Vice-president Dahik (requested by PSC leader and Ex-president León Febres Cordero), who subsequently went into exile. Governing was also made more difficult for President Durán given that the opposition parties in Congress joined ranks and formed a parliamentary coalition of PRE, FRA, MPD, ID, DP, and APRE (*Acción Popular Revolucionario Ecuatoriano*). The government lost even more credibility and legitimacy when a popular consultation held at the end of 1995 resulted in a huge failure.

1995: "Wartime Tax Measures"

The costs of the earlier mentioned military conflict between Ecuador and Peru of 1995 brought public finances into a precarious situation and measures to counterbalance the widening fiscal deficit became necessary. In May the government put forward a tax reform which became known as *"wartime tax measures"* (EIU, No. 1 1995) Its main elements were: a 2 per cent tax on the purchase price of all automobiles (valid for one year); a war tax equivalent to a two-days' salary paid by all public- and private-sector employees; and the removal of exemptions to VAT. While the first two measures found widespread support, the latter was questioned and criticised. Industrialists opposed this proposal by arguing that resources should be found by restructuring the budget instead of extending the coverage of VAT (EIU, No.1 1995). On a similar line many people in and outside Congress voiced their opposition holding the opinion that sufficient additional taxes would already be paid and that the focus should be put on improving tax collection instead (EIU, No. 2 1995). When decided in Congress, the removal of VAT exemptions was consequently rejected. However, the 2 per cent Vehicle Tax as well as the two-days' salary payment were approved by a great majority in the legislature.

"At the time of the military conflict with Peru a special tax on the value of motorised vehicles was created 'for one time only', which we paid with pleasure and knowing that it was for an absolutely justified cause, in which the Ecuadorian soldiers gave a lesson of manliness, strategy and bravery." Pablo Ortiz García, Superintendent of Companies (*El Comercio*, 30.12.96:5)

This statement of Ortiz García reflects well the spirit of patriotism prevalent in Ecuador during the conflict with Peru. Patriotic feelings led in this case to popular support for the tax measure proposed by the government. Popular support for the President had increased during this time, as reflected in some opinion polls: while President Durán's popularity rates had fallen to only 23 per cent in August 1993 one year after the beginning of his government (down from 51 per cent in August 1992), at the end of his term in 1996 these rose significantly to 38 per cent (*Cedatos*, 2004). Data for 1995 are unfortunately unavailable; it seems quite likely, however, that his popularity had been even higher at the time of the conflict. This general support for the government can explain why this tax reform was successful despite the fact that: a) a reform intent to increase taxes had failed one-and-a-half years earlier; b) this policy came in the third year of government with just one year to go to the next elections, a time when introducing new legislation usually becomes more difficult; c) the ruling coalition of PUR and PCE only held 13 per cent of seats in Congress. Under normal circumstances these conditions would have made the success of such a measure highly unlikely, yet the war opened a window of opportunity for the introduction of this change to the tax system. Modesto Correa, the finance minister[120] responsible for developing this policy

[120] Modesto Correa was Minister of Finance between September 1994 and April 1995. He thus left in the month before the reform was actually introduced.

proposal commented in an interview on the interplay between popular and congressional support:

"An additional tax of 2 per cent was very well received in society because in this moment there was a spirit of giving, of helping the country due to the conflict situation ... It was favourably received by the people and when the Congress saw that the people received this well and that public opinion said they would be willing to contribute, the dynamic at the Congress level worked out very quickly." (Correa, interview, 15.4.2004)

Yet, while it seems surprising that people would support an increase in their tax burden, it also needs to be pointed out that the measures proposed were moderate. Even though they introduced a new tax (2 per cent on vehicles) it was only a temporary measure (as was the two days' salary payment) and also represents a tax that generally attracts less opposition than, say, an increase in the VAT rate. The more long-term change of eliminating VAT exemptions was rejected. Taxing vehicles can easily be sold as a measure which is mainly paid by richer people leaving lower income groups unaffected. Mario Ribadeneira, who was finance minister during the first year of Durán's government (August 1992 – July 1993), commented on the policy chosen by his successor:

"It is a typical measure of desperation when resources are lacking. And here demagogy comes in as well. The tax on vehicles is a tax on the rich which is sold demagogically. So this is the easiest measure, a measure so elemental, so primitive, but for the very same reason so easy." (Ribadeneira, interview, 20.4.2004)

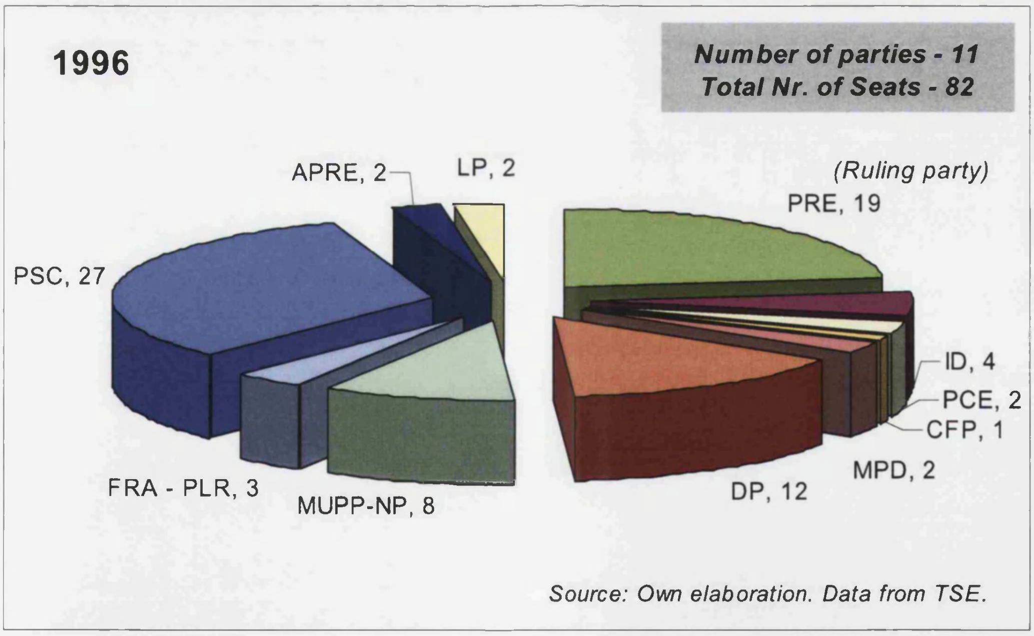
Yet, while certainly also chosen for demagogic reasons, the Vehicle Tax also had the advantage of allowing rapid introduction and collection. Money would come in quickly, which was what the government needed in a year of extensive unforeseen expenses.

Summary. The government of Sixto Durán Ballén attempted two tax reforms worth mentioning during its period in office (1992-96): the ambitious reform undertaken in 1993 resulted in a failure due to the widespread opposition in both Congress and society. During the last year of his government, however, Durán Ballén managed to introduce some – though modest - tax measures despite the limited partisan support he had in Congress. This can be largely explained by the situation the country experienced of the conflict with Peru, which had triggered popular support. Favourable public opinion, positive and rapid dynamics within the legislature represent a rather unique procedure in Ecuador. As former finance minister Modesto Correa pointed out Ecuador would consequently need to be in permanent conflict if it would want to have new tax reforms approved... (Correa, interview, 15.4.2004).

6.4 How Tax Reform Failed: The Government of Bucaram (1996-1997)

In 1996 Abdalá Bucaram from the populist PRE won the presidency. During his election campaign he promised to protect real incomes and create jobs and attacked the country's upper class. He announced that subsidies on basic foods and fuels would be increased and pledged better health and education services. Bucaram left open, however, how all this would be financed. While Ecuadorian presidents have often departed from their electoral platform once in power, Bucaram's policy-switch seems the most extreme. Shortly after assuming the presidency he quickly increased prices for cooking gas, electricity and petrol and started to privatise state-owned enterprises. His economic team around Minister of Finance, Pablo Concha, started working on a convertibility plan, which would introduce the Argentinean model of pegging the currency to the dollar. These measures and plans came much to the surprise of his electorate who had expected a rather more heterodox economic programme. The heralded social reform consisted of a few measures only, among them a social housing programme.

Figure 6.11: Composition of Congress 1996, Ecuador

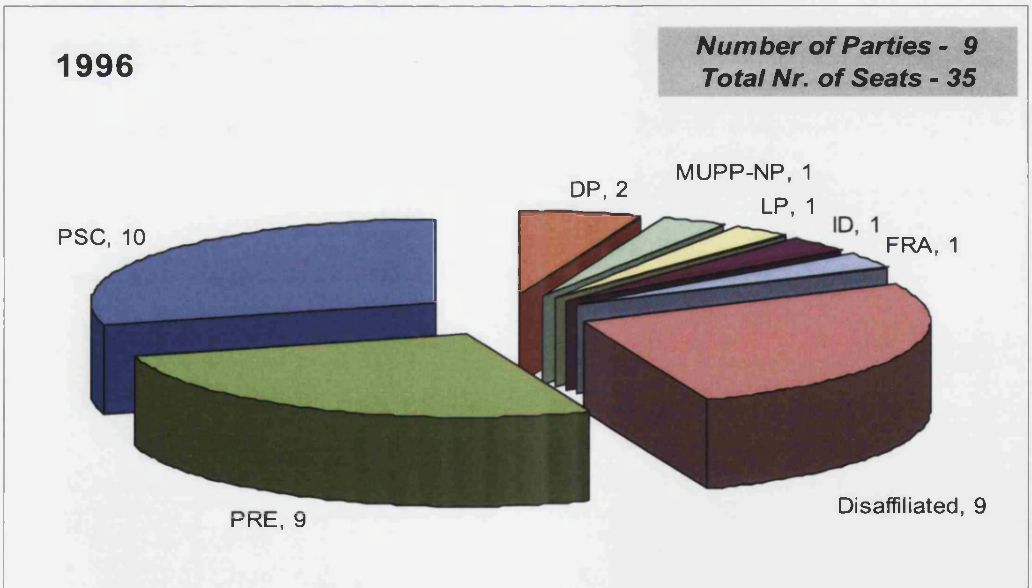


By far the largest party in Congress was the PSC, the party which had hoped to win the presidency in these elections; their candidate Jaime Nebot, however, only came second. President Bucaram's ruling party PRE gained 23.3 per cent of all seats in Congress (19 out of 82). The governing party managed to form a coalition with the FRA – the party of Alarcón who was to become Bucaram's successor – yet this party only held three seats in the 1996 Congress. It turned out to be extremely difficult for Bucaram to find support from other parties. The largest party in Congress, the PSC, was the party which had hoped to win the presidency in these elections, and was now not willing to support the PRE. Already during the election campaign Bucaram had used an approach that can hardly be called diplomatic. As Ex-Finance Minister Francisco Swett pointed out: *"Bucaram broke with all norms and patterns of behaviour and dedicated himself to insulting."* (Swett, interview, 15.4.2004). Often he was even offensive and while in government used words like *"rateros, maricas, and aniñados"* to refer to legislators of other parties (*El Comercio*, 6.1.1997:2). Burbano and Rowland summarised Bucaram's approach to governing during the first six months:

"Far from organising and executing a coherent government plan and call for agreement, the executive swept away with the political parties searching for the conformation of an official majority, dismantled the social movements and threatened the media with the aim of silencing the denunciations of corruption." (1998:83; my translation)

This style together with the fact that the traditional parties were reluctant to be seen as an ally of the populist PRE made the formation of alliances around legislative projects even more difficult than it generally is in Ecuador anyway.

Figure 6.12: Composition of Plenario 1996 (December), Ecuador



Source: Own elaboration. Data from Burbano & Rowland, 1998:82.

In the Plenario the situation looked a bit different. In the months following its installation in August 1996, several members of the Plenario had disaffiliated from their parties. Almost all these disaffiliated members supported the government (most probably Bucaram had made some kind of deal with them). Given the nine votes of the PRE plus one of coalition partner FRA together with around eight votes from the disaffiliated legislators, Bucaram held a fragile majority in the Plenario at the time of the tax reform (while being far from a majority in the full Congress).

Tax Reform 1996

A few months after coming to power Bucaram's government attempted to introduce his first major structural reform. This ambitious project aimed at increasing tax collection; when announcing it Bucaram stressed the need for improving collection and fostering tax culture (*El Comercio*, 1.12.96:10). In November 1996, President Bucaram sent the proposal as an urgent economic reform law to Congress. Its main elements were:

Table 6.13: Tax Reform, 1996

Tax Reform Attempt - 1996
a) A large increase in excise taxes levied on alcohol, cigarettes, and other luxury goods;
b) 2% Vehicle Tax. This tax had been in existence during 1995 to help finance the military conflict with Peru. The same tax was proposed to be continued and levied on all motorised vehicles less than five years old;
c) Elimination of VAT exemptions;
d) 1% (one-off) Tax on Companies;
e) Corporate Income Tax lowered from 25% to 20 (or to 10% if profits reinvested;
f) Harsher penalties for tax evasion (see Table 6.15).
Source: Own elaboration.

Minister of Finance Pablo Concha described the aims of the reform in an interview with *El Comercio* (9.12.96:2):

"We are not assigning new taxes; we are eliminating the distortion of the system and attacking tax evasion. The only new tax is the 2 per cent tax on vehicles and the 1 per cent tax on companies is a one-off tax. What does the reform hinge upon? On the elimination of distortions, evasion and corruption."

Concha's statement, while outlining the objectives of the tax reform, also implies a reaction to the criticism the project would receive, which held that the government planned to introduce new taxes.

Opposition from all sides. After this tax reform proposal was sent to Congress, opposition to it started immediately. PSC, DP (the largest and third-largest party in

Congress) and the ID stated officially that they would oppose the creation of new taxes. The MPD and *Nuevo País* also declared their rejection of the policy proposal. From the interest groups outside Congress the Bucaram government received varying signals: while the banking sector was mainly in favour of the reforms proposed, Quito's Chamber of Commerce opposed them arguing that they would provide an incentive for the smuggling of cigarettes and liquor (given the high increase of the excise duties for these products) (*El Comercio*, 3.12.96:B6).

Meanwhile the discussion of the new tax policy was started in the *Plenario* as the law was sent at a time when the full Congress did not convene (see Figure 6.12). The discussion mainly related to procedural matters at first, as members of the opposition questioned whether this project could be decided upon by the *Plenario* rather than in the complete Congress. Several legislators argued that the *Plenario* did not have the legal capacity to deal with this proposal. A member of the PSC, Flores Troncoso, stated that the project confused legislation with constitutional reforms (*Congreso Nacional del Ecuador, Acta No.* 14). He referred to the parts of the proposal which aimed at introducing harsher penalties for tax evasion. For such a measure constitutional changes were required, which in turn did not fall into the capacity of the *Plenario*, an extraordinary period of sessions in Congress would be necessary. This extraordinary session was exactly what the opposition was calling for. While arguing legalistically saying that the reform could not be discussed in the *Plenario* due to its constitutional contents, a strategic calculation was certainly also behind their argument: in a fully convened Congress, the opposition parties would definitely be in the majority, while this was not necessarily the case in the *Plenario*. After this point had been raised repeatedly, Fabian Alarcón, the President of the Congress, declared that a discussion on the reform proposed could not be carried out in the *Plenario*, for the reasons mentioned by various legislators. According to Article 6 of the *"Ley Orgánica de la Función Legislativa"* the President of the Congress has the right to convene an extraordinary Congress. After Alarcón met with President Bucaram regarding this issue, the latter decided to withdraw the project. A discussion of this project in the Congress rather than the *Plenario* was not in his interest given the more limited presentation of governmental legislators in that space.

Tax reform – second attempt. After the economic team around Minister of Finance Concha had revised the first reform proposal, the government of Bucaram presented its second version to the legislature some days later, on 10 December, 1996. There had been two substantial changes. On the one hand all parts relating to penalisation for tax evasion had been taken out to avoid any elements requiring a constitutional change. With this modification the reform proposal entailed only non-constitutional changes, which the *Plenario* could take decisions on. The second main change concerned the new rates for excise taxes. While the first version had provided for a huge increase in the tax rates for goods like tobacco and alcohol, the new reform proposal presented now contained significantly lower increases.

Excise tax. The excise tax was first introduced in Ecuador during the government of Osvaldo Hurtado (1981-84) where the collections were designated for creating an emergency fund for floods in the coastal areas. Under the subsequent government of President Febres Cordero (1984-88) excise duties were increased in order to fund health programmes. During the presidency of Borja (1988-92), then, excise tax rates for cigarettes, beer and other products were doubled. Several years later, in 1995, President Durán Ballén (1992-96) lowered the rates again: black tobacco (pipes and cigars), for example, was reduced from 25 to 15 per cent, and Virginia tobacco (cigarettes) from 100 to 67 per cent (*Ley* 110, 29.12.1995). The rates introduced by this reform were the ones the Bucaram government wanted to modify one year later in December 1996.

Table 6.14: Excise tax

	Until Dec. 1996	1st Proposal (28.11.96)	2nd + 3rd Proposal (9.12.96)
Virginia tobacco	67%	300%	103%
Black tobacco	15%	200%	48%
Beer	30%	80%	43%,
Alcohol (other than beer)	20%	240%	63%

Source: Own elaboration.

The first proposal set out to increase excise tax rates drastically: the rate for alcohol, for example, was to be increased from 20 to 240 per cent. After the government had announced this plan on the 28th of November, intense lobbying from the potentially affected industries started immediately. The tobacco industry (*Agro-industria Tabacalera*) mounted a campaign in the national newspapers, in which advertisements criticised the increase of the excise duty for cigarettes. The representative of Philip Morris in Ecuador, Sobalvarro, entered into conversations both with the government and with legislators from different parties trying to convince them of the damage an increase of the excise tax would cause to the industry. Santiago Bucaram, member of the PRE, reported about two meetings he had with the Philip Morris representative Sobalvarro (*El Comercio*, 11.12.96:3). Rafael Cuesta, legislator of the PSC, complained about the presence of Sobalvarro in the legislative space and asked the President of the Congress to ban the Philip Morris representative from entering the Congress (*El Comercio*, 9.12.96:3). The tobacco industry and especially Philip Morris had thus intensely lobbied the government to change the excise tax proposal. In consequence, the increased excise duties were cut significantly by the government. While alcohol, for example, was to rise from 20 to 240 per cent in the original plan the revised version now provided for a rate of 63 per cent (see Table 6.14 for other changes).

The second proposal in the *Plenario*. Upon receiving the significantly modified tax reform, the President of Congress Fabian Alarcón decided that the discussion could go ahead in the *Plenario* given that it had the power to discuss, approve or reject legal reforms presented by the executive. Only if no quorum would be reached in the *Plenario*, would he call for an extraordinary session of Congress. While the opposition parties (PSC, DP, ID, MPD, *Nuevo País*) acknowledged that some positive changes had been made they considered the second proposal essentially the same as the first and therefore maintained their opposition. Despite this negative reception of the new proposal by the main opposition parties, the government was optimistic about being able to get the reform through. PRE legislator Padilla stated that in addition to the votes of the government *"Apart from the 18 government votes, another two from the PSC and one of the ID will be added*" (*El Comercio*, 11.12.96:3). Yet only one day later *El Comercio* announced that the FRA – which had so far been part of the government – would withdraw arguing that they preferred being able to decide independently on legislative matters. A few days later the withdrawal of the FRA was ultimately confirmed when the Tourism Minister, Napoleón Ycaza (a member of the FRA) resigned. At the same time the FRA called on all its members holding positions in the public sector to do likewise (*El Comercio,* 15.12.96:C2).

The departure of the FRA meant that the government lost one crucial seat (vote number 18 out of 35) in the *Plenario*, where on the 18th of December the second tax reform proposal was discussed. At the beginning of the session 18 out of the 35 legislators were present: while the opposition was mostly gathered, all but one of the governmental legislators were absent. *El Comercio* (19.12.96:6) reported that President Bucaram had retained the PRE legislators from the session as they had not managed to mobilise sufficient votes for approving the legislation. The one PRE representative who attended the session, Santiago Bucaram, represented the 18th person necessary for reaching a quorum. However, in the moment the quorum was announced the latter left the room saying that without him they would be without a quorum (*El Comercio*, 19.12.96:6). In this moment the President of the Congress, Fabian Alarcón, decided to call for an extraordinary session of Congress as he was not willing to allow the proposed law to come into force by default.[121] It was certain that a quorum would be reached in the full Congress given that the opposition parties held a majority there (in the *Plenario* reaching a quorum was more difficult for the opposition as the government was close to holding a majority and as usually participation was not complete). For his decision to convene the Congress, Alarcón was later accused of beginning his treason against Bucaram by Victor Hugo Sicouret of the PRE (Sicouret, interview, 16.4.2004).

It became more and more likely that also this second reform proposal would be rejected or significantly modified given that the decision was now to be taken in the Congress where those opposition parties who had publicly rejected both versions represented the majority. Being aware of the potential failure, the government took recourse to outlining the negative consequences of rejecting the law: Finance Minister Concha announced that drastic cuts would become necessary as the current fiscal deficit was 6 per cent; in addition negotiations with multilateral organisations would be seriously affected (*El Comercio*, 20.12.96:1+6). Yet the next day, the 19th of December, things took a slightly unexpected turn as Alarcón decided to hold a session in the *Plenario* contrary to his previous pronouncement. In this space the government managed to secure a majority for having the first two articles of the reform approved. These articles, however, represented smaller elements of the reform (e.g. determining that all public entities would pay income tax). After this session Alarcón defended the decision to hold this session in the *Plenario* saying that he wanted to use this space to resolve the easier aspects before moving to the Congress (*El Comercio*, 20.12.96:6). One day later, on the 20th, the Congress convened and the project was largely rejected: out of the 11 articles discussed, seven were turned down, including the main provisions of the project. While the debate continued and a defeat of the reform became clear, President Bucaram sent a fax to the Congress and withdrew the proposed legislation (*Congreso Nacional del Ecuador*, Acta No. 2).

[121] If the *Plenario* would not pronounce itself about the law within 30 days after the proposal had been sent by the Executive, it would automatically be introduced by *"Ministerio de la Ley"*.

Tax reform – third attempt. A few days later, on the 23rd of December, the government of Bucaram sent a third version of the tax project. The proposal was scaled down significantly: only 11 articles were left (from previously 48) and major elements such as the elimination of VAT exemptions and the 2 per cent Vehicle Tax had been taken out. What was left were: the increase in excise taxes (the rates proposed were the same as in the second proposal); the 1 per cent Tax on the Net Capital of companies as a one-off payment; and the reduction of Corporate Income Tax from 25 to 20 per cent (or 10 per cent if profits were reinvested) (see Table 6.15). After this third proposal was sent, President of Congress Alarcón declared that he would proceed as previously: the bill would be treated in the *Plenario* yet should no quorum be reached there he would convene an extraordinary session of Congress. The government thus deprived of the potential strategy to leave the *Plenario* inquorate, accordingly made its legislators participate in the session. On the 27th of December, finally bringing this story to an end, the third version of the tax reform was largely approved by the *Plenario*, including all the main elements mentioned earlier. The approval of this third version of the tax bill can be explained by various aspects: Firstly, the government was close to holding a majority in the *Plenario* and the legislator of the former coalition partner FRA gave its support for some parts of the bill. The possibility of deciding on the bill in the *Plenario* rather than the full Congress thus gave an advantage to the government. Secondly, it was difficult for the opposition to maintain its rejection of the project after it was trimmed to such an extent that basically all elements previously criticised had been taken out. The former discourse of opposition to the creation of new taxes was no longer sustainable either. The opposition parties had consequently become more flexible and did vote in favour of some of the articles. Still, they continued to disapprove of some elements, yet due to unfortunate manoeuvring, they were unsuccessful and the proposal got through. This happened in the case of excise taxes. When it came to deciding on the article on the excise duties, 32 legislators (out of 35) were present: 16 from the government, Wilson Merino from the FRA, and 15 of the opposition. While the FRA had officially left the government a short while ago, legislator Merino voted with the government on several parts of the project. On the issue of excise taxes, however, Merino had made clear that he would vote against their increase. When it came to voting on this matter, the 15 legislators of the opposition left the room in a clear attempt to leave the *Plenario* without quorum. One of the legislators who had left – Luis Borja from the PSC – had a substitute (Humberto Delgado) who was known to vote with the government. Thus when Borja had left, Delgado took his place and the votes of the government rose to 17; at the same time the number necessary for a quorum was reached (17 from the government plus Merino from the FRA). In consequence, the article on excise taxes (and the main element of the third proposal) was approved. In retrospect one can only consider this as a mistake or miscalculation of the opposition: had they stayed and voted the result would have been 16 for the government and 16 for the opposition (given that Merino had previously announced he would vote against it). According to the rules, the article on excise duties would not have been approved (*El Comercio*, 28.-31.12.96).

Table 6.15: Evolution of Bucaram's Tax Reform

1st Proposal 28.11.1996	**2nd Proposal** 9.12.1996	**3rd Proposal** 23.12.1996	**Approved** 27.12.1996
Excise Tax: 8-300%[122]	Excise Tax: 8-103%		Approved
2% on cars		Withdrawn	---
VAT: elimination of exemptions		Withdrawn	---
1% (one off) Tax on the Net Capital of Companies			Approved
Corporate Income Tax: from 25 to 20%, or to 10% if profits reinvested			Approved
Tax Code: penalties of 2 to 5 years introduced for tax fraud	Withdrawn	---	---

Source: Own elaboration.

Why the Reform Failed

Looking at the evolution of the tax reform as undertaken by the Bucaram government and comparing what had been proposed in the beginning and what was ultimately introduced, the project can be considered as having failed. The outcome of this tax reform project was determined by several factors: the unfavourable situation the ruling party held in the legislature given their low share of seats; the consistent action of the opposition which had closed ranks after insults from Bucaram and the government's attempts to bypass the legislature; the constitutional right granted to the President of Congress to convene an extraordinary Congress, an option used by Alarcón to avoid having the law introduced by default which opened the possibility for the clear defeat of the second proposal; the influence of economic interest groups as regards the excise taxes; and the opposition parties' unfortunate manoeuvring leading to the approval of

[122] For individual rates see Table 6.14 above and Appendix G.

the new excise taxes. Finally, it should be mentioned that popular opinion played a rather limited role. Society largely did not take much notice of the tax measures proposed by the government as newspaper coverage of that period shows. Public opinion was only mobilised when it came to a more visible economic policy soon after the tax reform had failed.

From tax reform to the fall of President Bucaram. As both President Bucaram and Minister of Finance Concha had already announced when the tax reform was in danger, other fiscal measures would be necessary to reduce the deficit. Accordingly, a couple of days after the tax reform failed and little additional income from tax collection was to be expected, Bucaram announced an increase in the price of cooking gas on 8 January, 1997. This measure triggered a wave of protests throughout the country: demonstrations by pensioners, teachers, social movements such as the indigenous organisation *Confederación de Nacionalidades Indígenas* (Confederation of Indigenous Nationalities, CONAIE), the unemployed, Ecuador's main trade union, the FUT, and other groups were carried out throughout January protesting against the government of Bucaram and its economic policies. On the 5th of February protests were at their peak with a huge demonstration in Quito and other cities, which was called by some the largest mobilisation of the last 50 years (Ribadeneira, Hernández et al. 1997:227). The next day an extraordinary session of Congress was convened, which declared President Bucaram as mentally incapable to govern and named President of Congress Fabian Alarcón as interim President of the Republic.

While there is no direct link between the failed tax reform and the ousting of Bucaram there is certainly an indirect one. The opposition parties had become increasingly determined to overthrow the government. The Minister of Housing of the Bucaram government, Victor Hugo Sicouret, already interpreted the defeat of the tax reform as an indicator for the political parties' plan to bring an end to Bucaram's presidency: *"The National Congress rejected everything because they already wanted to bring down the government."* (Sicouret, interview, 16.4.2004). On the other hand popular protest played its role in bringing about Bucaram's ultimate overthrow after having been in power for only six months. Given the failure of the tax reform, the government of Bucaram was forced to take a fiscal measure for which the approval of the legislature was not needed – consequently, the price of gas was raised by presidential decree. It was this measure which triggered the massive protests, with more and more people calling for Bucaram to step down, which the Congress ultimately used as a justification for its decision to dismiss Bucaram.

6.5 Creation of the SRI during Alarcón Government (1997-1998)

In December 1997, during the interim government of Fabian Alarcón (1997-98)[123] an important reform creating a new, autonomous Internal Revenue Service (*Servicio de Rentas Internas*, SRI) was passed by Congress (*Ley* 41, 2.12.1997). The previous tax collecting body – part of the Ministry of Finance – was widely considered corrupt and inefficient. Teresa Minuche, former President of the Legislative Commission for Tax and Budget Matters (1992-93), commented: If you had gone to the Internal Revenue Service before 1997, *"you would have found some horrible offices, some terrible people without any training, who took bribes from the taxpayers."* (Minuche, interview, 25.3.2004). With the legislation introduced in late 1997 a process of institutionalisation was started, which significantly changed Ecuador's tax collection system. Once Elsa de Mena was appointed as Director of the SRI in September 1998, the organisation was completely overhauled: new offices were set up, computer equipment was renewed, and – most significantly – new staff was hired. All former members of staff had to undergo examinations, which were only passed by 35 out of the 1700 employees; all those who failed were dismissed (De Mena, interview, 20.4.2004). New staff was employed, trained and paid; a careers-based scheme introduced, salaries were raised (to reduce incentives for corruption), made transparent and allocated according to efficiency. The reform has generally been evaluated very positively as expressed by Simón Bustamante, President of the legislative commission responsible for tax matters at the time (1998-2000):

"Without a doubt, having created the Servicio de Rentas Internas *completely changed the system of tax collection in the country. Through this entity tax evasion was reduced significantly, collections improved."* (Bustamante, interview, 20.4.2004)

In the years after the SRI was set up, tax revenues started to increase particularly as regards the VAT: while revenues were US$756 million in 1997 by 2001 they had almost doubled to US$1,47 billion (SRI, 2004). Considering the significance of the legislation it seems surprising that it was introduced during the interim presidency of Alarcón. His government was able to introduce hardly any reforms at all, Beckerman (2002:35) stated: *"This government had inadequate political support for anything more than caretaking."* All of Alarcón's significant initiatives were turned down by

[123] Alarcón was from the small centre-right party Frente Radical Alfarista (FRA), which held only three seats in Congress at that time.

Congress; in early 1998, for example, it proposed a series of tax measures (such as a tax on gross corporate income, an increase in the VAT rate) but these were opposed by Congress and the society at large and therefore failed.[124] Why, then, did the law to establish the SRI pass in December 1997? It seems likely that the legislature simply did not realise the potential scope of this reform. Gustavo Arteta from the think tank CORDES (*Corporación de Estudios para el Desarrollo)*, who described the introduction of the legislation as "a miracle", maintained:

"Maybe they thought that this was a question of an arrangement of bureaucrats, an issue where nothing would happen and in the end they said yes. ... This is what I think happened there, one of those things that was approved and would have no impact whatsoever and which was a matter of makeup like in many other cases of institutions where they change the name and in the end it continues as before." (Arteta, interview, 7.4.2004).

The Director of the SRI, Elsa de Mena, argued in a similar way and considered that the legislators *"definitely did not realise ... they approved the law but never believed that this law could give rise to a transformation of the tax administration."* (De Mena, interview, 20.4.2004). Former Minister of Finance, Pablo Better, considered the measure "superficial" when it was proposed and only later realised the difference it made (Better, interview, 30.3.2004). Another indicator is that the newspapers did not take any notice of the discussion surrounding this bill at the time, and no reporting took place. Both within the Congress and outside it, then, the legislation relating to the creation of a new tax agency was not considered as significant, which explains why it passed during the otherwise rather uneventful government of Alarcón.

Conclusion. The cases considered in this chapter provide ample evidence that specific institutional provisions had a significant influence on presidents' possibilities to introduce tax legislation: In 1986 the constitutional decree powers allowed President Febres Cordero to introduce a significant increase in the Sales Tax. The reform of 1989 was possible mainly – though helped by popular support – because of the constitutional provisions regarding the *Plenario*, which allowed President Borja to have the reform approved in a space where his party held a majority. The governments of Durán Ballén, Bucaram and Alarcón largely failed to introduce their tax reforms undertaken in 1993, 1996, and 1998 due to the lack of congressional support. That Durán Ballén managed to have some small tax changes introduced in 1995 was because of the extraordinary

[124] The only significant change to the internal taxes that was passed was a lowering of the excise taxes: from 8-103% to 8-75% (for individual rates see Appendix G). By way of this law the changes passed by Bucaram only half a year earlier were practically reversed (*Ley s/n*, 31.7.1997).

situation given the conflict with Peru; the passing of the bill to restructure the Internal Revenue Service under Alarcón in 1997 can be explained by the Congress's failure to grasp the significance of the reform.

No evidence was found that external actors played a significant part in putting tax reforms on the agenda. Though in the case of the 1989 reform, for example, Ecuador was influenced by reforms carried out elsewhere in the region, there was no pressure from the multilateral institutions, which only started to be concerned with tax reform from the early 1990s.[125] Given the consultative process employed by the government no substantial public protest occurred in 1989. In 1993, on the other hand, protests by trade unions and social movements against the tax measures were widespread and backed up the opposition parties' rejection of the bill in Congress. When Bucaram attempted his tax reform in 1996, society took little notice and protest only evolved once Bucaram had introduced the more visible measure of a price increase. As regards business groups, though they managed to gain minor changes to some of the tax policies, they did not have a major impact. In 1989 the private sector achieved only a few concessions from the government as a response to their criticism of the bill; in 1993 its opposition strengthened the general rejection; and in 1996 business groups had an effect on one aspect of the tax bill, as lobbying of the tobacco industry led to the introduction of a much lower excise tax increase than planned.

In short, while popular support or opposition played some role in the fate of the 1989 and 1993 tax bills, it was principally the internal dynamics of the Congress that determined the outcomes.

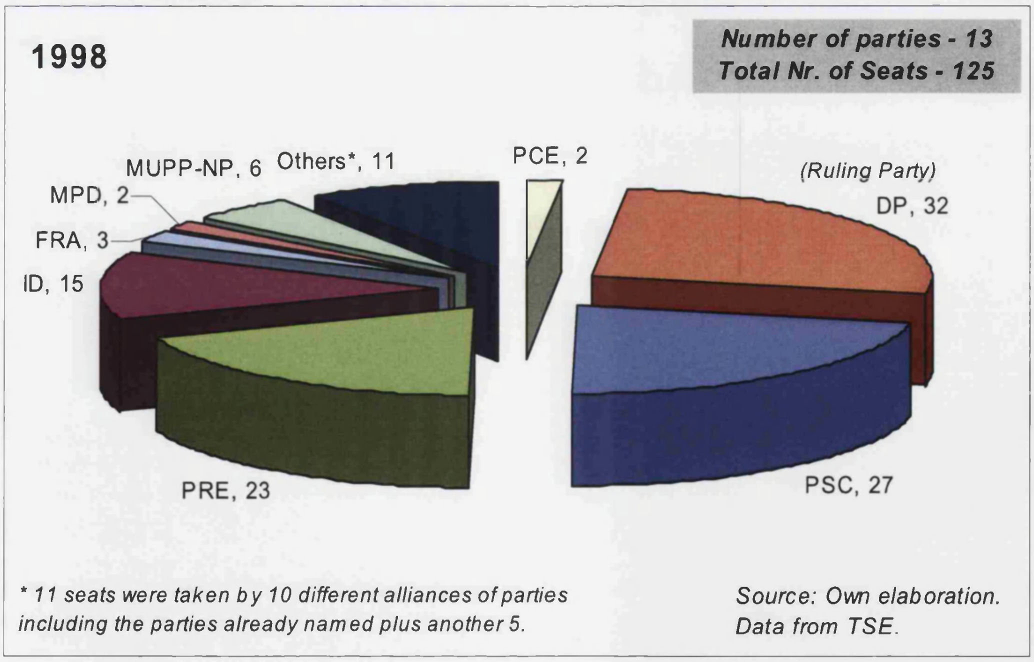
[125] That tax reform was not on the multilateral organisations' agenda in the 1980s becomes clear, for example, when tracing their publications record on the issue: the first paper of the World Bank dealing with tax reform was published in 1991 (IBRD, 1991).

7 Ecuador: Tax Reforms during the Governments of Mahuad and Noboa (1998-2001)

7.1 Frequent Changes to the Tax System: Mahuad's Government (1998-2000)

After a situation of high political instability culminated in the overthrow of President Bucaram in February 1997, and a period of a "lame duck" interim government during the presidency of Alarcón, Jamil Mahuad of the DP was elected as Ecuador's new President in July 1998 and subsequently assumed power in August. One of the most striking features of this election was the fact that the PSC had not put forward a presidential candidate. In the previous elections the PSC candidate Jaime Nebot had come second; the fact that one of the most important parties of Ecuador's political landscape would not have a candidate running for the presidency was significant. It is commonly held in Ecuador that Mahuad got to the presidency with the help of the PSC, which facilitated votes for him especially from the coastal areas (*El Comercio*, 14.11.98:5). Mahuad was elected with 51.2 per cent of the votes against 48.8 per cent of his opponent, Alvaro Noboa of the PRE (TSE, 2004). This close result did not provide Mahuad with a particularly strong mandate, however.

Figure 7.1: Composition of Congress, 1998



Yet some aspects seemed to provide President Mahuad with an advantage compared to other Ecuadorian governments: Mahuad's ruling party DP was the biggest party in Congress, something that between 1984 and now had only been the case during the Borja government. In addition, the DP counted on the second largest share of seats held by a ruling party during the same period: 28 per cent (or 35 out of 125 seats).[126] Given that the Congress was highly fragmented with 13 parties represented, it was nevertheless clear that governing would be difficult.

Economic situation and policies. In his election campaign Mahuad made rather specific promises (partly triggered by the huge promises made by his opponent Alvaro Noboa who was running for the PRE): subsidies would be targeted on the poorest sectors, he would create thousands of jobs, build new hospitals and homes for the homeless, yet despite these expenses the inflation rate would be kept down (Carriére, 2001:144). These promises were difficult to keep, however, given the dire economic situation of the country. When Mahuad took over the presidency he inherited a hugely difficult economic situation: the fiscal deficit was around 7 per cent of GDP; inflation reached 45 per cent; oil prices were at an extremely low level of approximately US$7 a barrel; costs to repair damages caused by the climatic phenomenon El Niño were nearly US$300 million; debt servicing represented 41 per cent of the budget (Carriére, 2001:144); and the trade deficit was more than US$1 billion for 1998 (Lucas, 2000:29). Economic measures to tackle this situation were to be expected and Mahuad made his first moves about a month after taking office: in September he devaluated the currency and subsidies were eliminated making the price of cooking gas rise by 510 per cent, diesel by 39 per cent and electricity by 353 per cent (*El Comercio*, 15.9.98:1). Simultaneously, however, a voucher system benefiting mothers below a certain level of income was introduced to counterbalance the cancellation of subsidies. The elimination of subsidies resulted in a huge loss of popularity for Mahuad: while he had enjoyed rather high levels when coming to power, his rates fell by 33 points (from 77 to 44) within only eight days of announcing this measure (*El Comercio*, 22.11.98:3). Faced with considerable protest, Mahuad re-introduced the subsidies later on. During the first months of his presidency, Mahuad dedicated his time mainly to the peace negotiations with Peru with which Ecuador had been in a military conflict in 1995. His attempts were successful and in October 1998 a peace agreement was signed.

[126] The ID during the first half of the Borja government (1988-90) held the largest share held during the last two decades: 42.3%.

Part I: Tax Reform 1998

At the same time as a devaluation and elimination of subsidies, President Mahuad and his economic team announced a major tax reform, one of its main elements being an increase of VAT from 10 to 14 per cent. This proposal, never formulated concretely in writing, received a lot of criticism and found no support among political parties in Congress. Soon after the VAT reform had been suggested by the government, the leader of the main opposition party in Congress, Jaime Nebot of the PSC, came up with an alternative plan: income taxes should be abolished and replaced by a 1 per cent Financial Transactions Tax (FTT), levied on all operations carried out via financial institutions. The rationale behind this proposal was explained by the current PSC leader and legislator during the period, Xavier Neira:

"We proposed it as a way to search for an alternative formula to a tax which no one paid to one that everyone would pay, because everyone draws cheques." (Neira, interview, 16.4.2004)

A certain populist discourse was also used to convince as the PSC pointed out that the tax on financial transactions would mean taxing the rich since it was the rich who circulated money and not the poor. Yet the intention was possibly rather the opposite: Sandoval, who played a crucial role in developing the 1989 reform, claimed that it was in the interest of Guayaquil's entrepreneurs – who he considered are represented by the PSC – to replace the income tax by an FTT as the latter one would be easier to evade (Sandoval, interview, 26.3.2004). The PSC shared the policy proposal not only via the media but also with the government and all parties represented in Congress and initiated an informal discussion about it. Parties like the ID voiced their criticism of the proposal by sending a statement to Jaime Nebot pointing out that they could accept the FTT only if it would be introduced complementary to the income tax; MUPP-NP had a similar view, and the PRE rejected the FTT completely (*El Comercio*, 20.10.98:6). Formally, however, the PSC had no possibility whatsoever of presenting its proposal officially: while legislators used to have the right to present bills regarding any issue to Congress, this right had been restricted by the new Constitution that had come into force in 1998. Article 147 says that *"Only the President of the Republic can present projects for laws which would create, modify or abolish taxes, increase public spending or modify the political-administrative division of the country."* (Constitution 1998. My translation). The only possibility open to the PSC was thus to convince the government of its ideas.

The government, which had considered the alternative proposal made by Nebot, gave signals that it would take up the idea of an FTT but was not willing to abolish the income tax as they wanted to keep the constitutional principles of progressiveness and equality of the tax system. Finance Minister Fidel Jaramillo is reported to have said on the 19th of October that the executive was thinking of including Nebot's proposal but that at no time would it replace the income tax (*El Comercio*, 7.11.98:2). On this line the government presented its proposal on the 23rd of October, which contained: a) lowering the income tax to 10-20 per cent (from 25 per cent top rate); b) a Financial Transaction Tax of up to 1 per cent; and c) eliminating VAT exemptions (see Table 7.2). The government had hence decided in favour of a "mixed formula": keeping (a lowered) income tax *and* introducing the FTT. While Mahuad's government had thus clearly made an effort to find a compromise and had even completely abolished its original proposal to increase the VAT rate, the PSC, however, was firmly opposed to this proposal. Jaime Nebot asserted that the mixed formula would *"denature"* the FTT (*El Comercio*, 10.11.98:2) and PSC legislator Marcelo Dotti announced that the votes of the PSC were conditioned on the government's proposal to be exactly the same as the one originally suggested by Nebot (*El Comercio*, 8.11.98:3).

After it became clear that the PSC would vote against the reform suggested by the government and after another two weeks of discussion, President Mahuad backed in and did not go ahead with sending the mixed formula to Congress. Instead, he sent the pure FTT proposal – as invented by the PSC – to the legislature on the 9th of November. A 1 per cent tax on financial transactions was to be introduced and the income tax (both personal and corporate) abolished; the suggestion to eliminate VAT exemptions had been taken out. The only slight modification that Mahuad's government made to the PSC proposal was that they put a condition on the existence of this change to the tax system: the FTT was to be maintained as long as it would render US$600 million per year (around 3 per cent of GDP), otherwise income tax would be automatically reinstated in 2001.

Table 7.2: Proposals for Tax Reform 1998

14.9.1998 VAT Proposal	23.10.1998 "Mixed Formula"	9.11.1998 Financial Transactions Tax
VAT 14% (from 10%)	a) Income Tax 10-20% (from 25%) b) Financial Transactions Tax - up to 1% c) elimination of VAT exemptions	a) Income Tax abolished b) 1% Financial Transactions Tax

Opposition to FTT. After the announcement of the plan it was immediately rejected by several parties in Congress including the ID, PRE and MUPP-NP (*Movimiento Pachakutik - Nuevo País*), who stated clearly that they would vote against this proposal. Disapproval came also from a wide range of economic experts who did not approve of the FTT on technical grounds:

"With some professionals we had opposed this system for the effects it would provoke in the system and also because it would result in an inequitable taxation." (Ruales, SRI, interview, 23.3.2004)

Technocrats also referred to similar taxes having been introduced in other Latin American countries and, for example, in Argentina, Venezuela and Uruguay this tax was abolished after a couple of months since it did not bring the expected results (*El Comercio*, 9.11.98:3). Gustavo Arteta, Academic Director of the influential think tank CORDES, confirmed in an interview that the FTT *"was introduced despite all the technical recommendations"* (Arteta, interview, 7.4.2004). Perhaps even more significant is that Mahuad's own economic team was opposed to the PSC proposal as well and favoured the mixed formula. As Francisco Swett, President of the Central Bank at that time pointed out: *"Mahuad accepted it against his economic team's point of view."* (Swett, interview, 15.4.2004). In particular, Minister of Finance Jaramillo was against abolishing income tax as his earlier mentioned statement shows; *El Comercio* (8.11.98:3) reported him to have defended the mixed formula until the last day. The same newspaper repeatedly reported on the unfavourable opinion towards replacing income tax by the FTT within the Ministry of Finance more generally (see also Ortiz, interview, 30.3.2004). The Minister of the Administration, Ana Lucia Armijos, proposed a mixed form in which the 1000 biggest companies pay income tax just one day before the ultimate proposal was sent to Congress (*El Comercio*, 9.11.98:3). There is thus ample evidence that Mahuad acted against his economic team when he decided to ignore both proposals they had elaborated (the VAT increase and the mixed formula).

Criticism came also from multilateral organisations who considered the FTT as an anti-technical tax for the distortions it created in the financial sector. IMF officials criticised the measure repeatedly and even after the proposal was sent to Congress, IMF head Camdessus questioned a tax on financial transactions by referring to the negative experience of other countries with this type of tax (*El Comercio*, 17.11.98:B1).[127]

[127] See also Chapter 5.3 on the view of multilateral organisations on financial transactions taxes.

Finally, opposition was voiced within Mahuad's ruling party DP. The party had traditionally held a view of a just tax system assured by a progressive income tax. By abolishing it, according to their view, it was no longer ensured that who owned more would also pay more. The FTT proposal thus shattered their long held views and several members of the DP opposed the measure. Raul Hurtado, Vice-President of the Legislative Commission for Tax, Fiscal, Banking, and Budget Matters and DP member, stated: *"The Democracia Popular was internally opposed to this reform but externally it had to vote in favour of the reform in Congress."* (Hurtado, interview, 13.4.2004).

FTT approved by Congress. Despite this criticism from several sides, Mahuad stood by his plan and the FTT proposal submitted by the executive went through the traditional procedure in the legislature. It seemed certain that the proposal would have sufficient votes for approval as the DP, PSC and some smaller parties who had declared their support for the project represented a clear majority. However, before it came to the final discussion on Congress, it seemed for some time that the tax reform was in danger: in mid-November some legislators of the ruling DP who had been rebelling against the tax proposal made an attempt to change course. They tried to bring the mixed formula back on the agenda and negotiated with other parties in Congress to form a majority for this proposal. Given that those parties who had previously supported this idea – such as the ID or MUPP-NP for example – continued favouring the mixed formula, chances did not look too bad. However, only a few days later President Mahuad called his legislators to order and any attempt to topple the president-backed proposal for an FTT came to an end. After a short delay caused by this incident, the tax reform was approved without modifications by Congress – with the votes of the PSC, DP, FRA, PC (*Partido Conservador*), and MCNP (*Movimiento Ciudadanos Nuevo País*) – in late November (*Congreso Nacional del Ecuador, Acta No.* 43).

Why Mahuad accepted FTT. Considering the opposition Mahuad faced both from his own ranks and from outside the question is why he accepted Jaime Nebot's proposal. Mahuad's own statements give some evidence for this: he reported that in a meeting with his economic team someone said that if an economics student would have proposed the 1 per cent on financial transactions he or she would not have passed even the subject *Finances I.* Mahuad replied that the student might not pass Economics but would certainly pass *Public Administration* (*El Comercio*, 12.11.98:4). The anecdote makes clear that Mahuad was probably not totally convinced of the economic measure as such but was aware of the political realities, which did not allow him to introduce a policy of his choice. In an earlier interview President Mahuad said: "*If it would be in my hands to introduce the tax reform, I would do it. But it is not. Therefore, I invited the Congress* (to discuss it, SL)." (*El Comercio*, 20.9.98:3). The political situation was that while Mahuad's ruling party held a comparatively high number of seats in Congress, these represented less than a third of the seats thus far from the majority. Alfredo Arízaga, who would become finance minister later during this government, evaluated the situation of President Mahuad as follows:

"*Mahuad wanted to increase tax collection and did not have a majority in the Congress; he had to form a majority with someone, the party* Izquierda Democrática *and all the parties of the left refused to raise taxes... And the* Partido Socialcristiano... *sustained that the income tax was a perverse tax and that they would be willing to support an initiative of the government given their initiative would be adopted which was the Financial Transactions Tax.*" (Arízaga, interview, 31.3.2004)

It does not seem particularly co-operative to offer support for one's own initiative, yet the PSC's strategy to just hold on to its own proposal without the slightest willingness to negotiate was ultimately successful. While the PSC was thus certainly not the easiest partner, it was a party that brought several advantages with it. Choosing this party, which was the second biggest, meant that just this two-party alliance practically held a majority in Congress. No further agreements with other parties were necessary; this was a much easier arrangement than a multi-party agreement. The PSC also seemed the best option as there was some overlap between DP and PSC as regards their economic visions. The "*socialcristianos*" had already voted with the government of Mahuad on a number of issues (for example the peace treaty with Peru) and also had not opposed the elimination of the subsidies in September (since this was introduced by decree there was no vote on this issue but during the discussions the PSC showed some tacit agreement while Mahuad received harsh criticism from other political parties). Certainly, Mahuad also looked to the future – given that he was only at the beginning of his government he would need a coalition partner for the rest of the term. Political analyst Simón Pachano explained Mahuad's choice in this sense as he drew attention to the fact that the government needed the PSC's support for its modernisation plan. Given the composition of Congress, according to Pachano, forming a stable majority for the executive's modernisation plan without the PSC would have been impossible (*El Comercio*, 21.11.98:3).

Considering the above, Mahuad's decision in this case can be interpreted as political pragmatism: rather than not being able to introduce any reform at all, he preferred to take the politically viable way even though that meant fully adopting the proposal of another party.

"I chose this way, because on the 31st of May, when in the evening the composition of the Congress was known, any objective analyst came to the conclusion that the country would remain without a tax reform. The PSC had signed documents before a public notary stating that they would not touch taxes. And thinking that the extreme left would vote in favour of raising taxes, thinking that popular groups would vote for this, is impossible. And my people would play on my side but we did not reach 51 per cent of the votes." (President Mahuad in an interview with *El Comercio* 22.11.98:3).

Mahuad's statement makes clear he thought to only have the choice of either accepting the PSC proposal or not achieving any tax changes whatsoever. This pragmatism was also expressed by the fact that he chose to assign a potential temporary character to the new tax: should the FTT not raise a certain amount of income, it would be abolished and a new – and improved – income tax would be established. Another aspect is important for explaining why Mahuad accepted the FTT proposal: the FTT was a tax that would bring regular income rather than once a year as the income tax. Money would be flowing in just a few months after it was decided upon, and collection was expected to be higher than it had been for income tax. The government calculated that around US$700 million would be raised in 1999 (*El Comercio*, 10.11.98:2), which represented around US$220 million more than collected otherwise (*El Comercio*, 7.11.98:2). With this money, Mahuad would have resources available to fulfil his announced programmes to a certain extent. Several people referred to this "cash flow argument" as a decisive element, including Victor Hugo Sicouret from the opposition party PRE but also Francisco Swett, President of the Central Bank and partisan of the PSC (Sicouret; Swett, interviews, 16.4.+15.4.2004). In addition, President Mahuad himself admitted this indirectly: when asked in an interview by *El Comercio* (22.11.98:3) why he had accepted it and if it was because of the bucket of money the tax offered on a daily basis, he answered that the point mentioned would be already sufficient for seriously considering such a tax.

Effects of FTT. While the income generated by this tax even exceeded the calculations made by the government, the overall effects of introducing this tax were generally evaluated as negative. Ex-finance minister Jaime Morillo Battle (1975-76, 1981-82) commented: *"This provoked an incredible chaos, provoked capital flight, provoked that many transactions started to be carried out on the margins of the banks and that deposits in the banks went down."* (Morillo, interview, 7.4.2004). Many of the bigger companies took to depositing their money abroad, and were thus able to avoid paying the tax. According to some estimates capital flight reached US$400 million in January 1999 (McConnell, 2001:73-4). Many people saw the increasing decapitalisation of the banks as a major factor contributing to the banking crisis Ecuador experienced in 1999 (Arízaga, interview, 31.3.2004).

Evaluation of 1998 tax reform. It is difficult to classify this episode of tax reform into a success-failure scheme as on the one hand, the proposal ultimately sent by the executive to Congress was fully approved and could thus be considered as a success; on the other the reform attempt can be seen as a failure as President Mahuad was forced to completely give up his original proposal. Economist Pablo L. Paredes pointed out that making compromises is a common process in politics, but in this case the government had to give in very much (Paredes, interview, 7.4.2004). There are several reasons why an opposition party (PSC) was able to determine the tax agenda by itself: in a first phase Mahuad was rather absorbed by his negotiations for a peace treaty with Peru which was finally signed in late October. While this represented a significant political achievement, it meant that economic policies were not a priority for him during these early months of his presidency. Since the government was busy with other things, the PSC used its chance to bring into play its own plans for tax reform. The procedure around the introduction of this reform was rather novel: generally it is the executive that proposes a reform, sends it to Congress and then tries to find sufficient support. In many cases, such as that of Bucaram's attempt to introduce a tax reform (see Chapter 6.4), this procedure did not work and reforms failed (or at least were drastically modified) as governments simply did not find enough partisan support for their approval in Congress. Mahuad managed to avoid such a failure – and it seems certain his government's original proposal to increase the VAT from 10 to 14 per cent would have been defeated had he sent it to Congress without any previous consulting. Mahuad chose to consult first and to submit his bill to the legislature only when he was certain that he had formed a majority for it. Already at the beginning of the process to introduce a tax reform, President Mahuad explained his approach in an interview with *El Comercio*:

"Usually, what they do here is to send the project without talking beforehand and I believe here you have to talk, invite the Congress to have a discussion, have meetings, exchange concepts, see on which points there is an agreement and on which points there is not. Then we elaborate a proposal that could be acceptable." (*El Comercio*, 20.9.98:3).

This approach of discussing first and building an acceptable proposal has some parallels to the reform undertaken in 1989 (with the difference of course that then it was the government's proposal which was accepted in the end) where Borja's government also went through a consultation process before sending it to Congress. A difference was, however, that in the case of the tax reform of 1998 public opinion seems to have played a limited role. Society's focus was on the economic measures taken by Mahuad in September and protests were aimed at reversing the elimination of subsidies which had led to a huge price increase for gas and electricity.

April 1999: Tax Reform Part II

Economic situation. In early 1999 the economic situation deteriorated further as the fiscal deficit, as calculated in early April, stood at 7.3 per cent of GDP (*El Comercio*, 1.4.99:B3). During the first months of the year unemployment rose dramatically and according to the Labour Ministry 400 companies went bankrupt between January and April 1999 causing around 90,000 people to lose their jobs (Lucas, 2000:31). 1999 was particularly marked by the crisis in the financial sector: between November 1998 and February 1999 five banks crashed and were then bailed out by the state, with the costs reaching around US$1 billion (Lucas, 2000:9). On the 9th of March President Mahuad announced a bank holiday and deposits were frozen to prevent a massive withdrawal of money. One week later banks were re-opened and the freezing of deposits was relaxed. Especially due to the difficulties in the banking sector, the government faced huge extra expenditures that necessitated further efforts to rectify public finances. Social spending was cut by 50 per cent in real terms during the whole of 1999 (Lucero, 2001:62); in mid-March the government took to increasing fuel prices by 163 per cent, which triggered massive protests in the society so that in the end, President Mahuad agreed to lower them.

Tax reform. Additionally the Mahuad government proposed Congress a tax reform in early March of which the main element was a VAT increase from 10 to 15 per cent, and also planned to introduce a Vehicle Tax of 4 per cent (see Table 7.3). Given the categorical refusal of the PSC to give its support for any measure that would entail raising taxes or introducing new ones (other than the FTT), the government changed its course and broke off from the coalition partner with whom it had introduced the FTT legislation of November 1998 and in whom it had set hopes for a more long-term co-operation. Instead Mahuad turned to the other parties represented in Congress. Yet his proposal to changing the VAT rate again (just as in September 1998) did not find any supporters and the government gave up this plan when it had become clear that it was not politically viable. The government of Mahuad then started to discuss with various parties – DP, ID, MUPP-NP, MCNP, MPD, PSE and PC – which showed some willingness to co-operate and this alliance then worked on a joint proposal. Economic analyst, Gustavo Arteta, commented on this process:

"There was no consensus to increase the VAT but there was a consensus on all these other reforms, so that in this process the government distanced itself from the Partido Socialcristiano *... they put back the income tax and this was approved with a coalition of the centre and the left, the centre, centre-left, and the left. Thus it was a complete rupture with the right, the social-christian right, thinking of the Christian-democrats (DP, SL) as centre-right. It was a total political change."* (Arteta, interview, 7.4.2004)

The proposal the newly formed coalition finally agreed upon was made public in late March and contained the following changes to the tax system:

a) reinstatement of income tax (at a lower rate than previously);

b) abolition of FTT (from 2000)

c) elimination of VAT exemptions (maintained for basic food items and medicine);

d) 2-4 per cent luxury Vehicle Tax (2 per cent for cars worth ECS120-200m; 4 per cent on those of higher value);

e) 1 per cent Tax on Corporate Assets.

The main element of this rather comprehensive programme was the re-introduction of the income tax, which had been abolished only several months earlier. The reform also intended to create two additional taxes: a Vehicle Tax (which was similar to the one that had also been installed for one year during the Durán government as a "wartime tax measure" and which Bucaram tried to introduce in December 1996 but failed) and a 1 per cent corporations tax (similar to the one valid in 1997 as introduced in Bucaram's term). Another significant aspect was the elimination of VAT exemptions which had been tried unsuccessfully by many governments. Soon after this agreement was reached, the government sent the project as an urgent economic law to Congress, thus allowing 30 days for a decision by the legislature. While things seemed to be steering towards a quick approval, a delay occurred as some of the seven parties involved in the alliance started questioning some aspects of the version sent by the executive. Some of the points questioned did not directly refer to the tax reform but to other elements entailed in the *Ley de Reordenamiento de las Finanzas Públicas* (Law of Restructuring the Public Finances). Thus the government of Mahuad entered again in discussions with MUPP-NP (which questioned the process outlined for salary increases) and also the ID, which was the most important coalition partner as it counted on 17 seats in Congress while the others only held six or less. After agreeing to some compromises, the executive sent a revised version to Congress in early April. However, this version included no major changes.

On the 15th of April the Congress initiated the final debate and a part of the project was approved. A few days later Guayaquil's Chambers of Commerce, who had been opposed to various parts of the tax reform (especially the creation of new taxes and the changes to the tax code), announced that it would organise a strike on the 22nd paralysing production throughout the country to try and stop these measures. Francisco Alarcón, President of the Chamber of Industrialists, railed against the reform:

"... this project which circulates in the Congress and which will finish off the productive sector of the country. We are fighting against this law and against the reforms to the tax code which are monstrous." (*El Comercio*, 20.4.99:2).

The opposition from this side and the announced strike (which did not really take off) did leave the Congress largely untouched. In the following days the remaining parts of the tax reform were approved with the votes of the earlier mentioned parties. Out of 62 articles only two minor ones were rejected: a) a change in the tax code allowing the closure of establishments which do not pay their taxes, b) tax on concessions for beach areas levied on the prawn industry.

Table 7.3: Tax Reform April 1999

Proposed	Approved
VAT increase from 10 to 15% 4% Tax on Vehicles	a) Income tax reinstated (as of May '99) - top rate 15% (from 25%) b) 1% FTT maintained in 1999 (abolished in 2000) c) Tax on luxury vehicles of 4% on cars worth more than ECS200m payable in 1999 only; 5% on helicopters, planes, yachts in 1999, 2% thereafter d) Elimination of VAT exemptions e) 1% Tax on Corporate Assets valid in 1999 f) Modification of tax code to improve collection and prison penalties for tax evasion established

Source: Own elaboration.

While the project had hence gone through Congress almost unaltered, President Mahuad took recourse to his veto power as provided by the Constitution and tried to impose some last refinements: he re-introduced one of the two rejected articles and suggested that the FTT should be kept as an advance payment also in the year 2000. The Congress managed to mobilise a two-thirds majority to override the latter veto as the published law shows: the *Ley 99-24* from 30 April, 1998 determined that the FTT would be abolished as of 2000. The other veto, however, went through and the change to the tax code was introduced. Later on this provision would lead to a process of great consequence as the national tax authority (SRI) carried out a very visible campaign closing down tax evading shops and marking them with big posters (Arteta, interview, 7.4.2004). The campaign is held to have helped raise tax collection considerably.

Table 7.3 shows the main elements of the tax reform approved in April 1999 (and compares it to the original government proposal).

Summary. In the tax reform undertaken in April 1999, the government again did not manage to have its original proposal implemented as an increase of the VAT rate was rejected by all political parties in Congress. The government itself considered the project to have failed as indicated by Ana Lucia Armijos, Minister of Finance at that time:

"What is being discussed in Congress was not the government's original proposal. The adequate thing to do would have been to raise the VAT, correcting the exonerations." (El Comercio, 13.4.99:2)

While the original project thus failed, ultimately some significant changes to the tax system were introduced, approved by an alliance between ruling party DP and other parties from the centre, centre-left, and left. Private sector group opposition failed to influence the tax reform.

November 1999: Tax Reform Part III

Despite the tax reform of April 1999 and some other fiscal measures, the economic situation deteriorated further during the remainder of the year. Oil was at an all-time low price at only US$7 per barrel. Given the significant dependence of the Ecuadorian economy on the income generated by oil, the influence of this fall in export earnings on the already strained public finances was enormous. The sucre devalued dramatically, reaching 25,000 to the dollar by Christmas 1999 (McConnell, 2001:75). In September 1999, Ecuador saw itself forced to default on its Brady bonds (worth US$5.6 billion). No other country had so far defaulted on its Brady bonds and Ecuador was increasingly losing the confidence of foreign investors. Remaining on good terms with the multilateral credit agencies, such as IMF and World Bank, was more important than ever in this situation and the Ecuadorian government negotiated about a stand-by agreement with the IMF during autumn 1999. The IMF had made it clear that a VAT increase (to 15 per cent) would be a prerequisite for this agreement as was clearly stated by its representative in Ecuador, Jeffrey Franks (*El Comercio*, 1.10.99:B1; 27.10.99:5). Facing the critical economic situation and influenced by the demands of the multilateral organisations the government of Mahuad developed yet another tax reform and sent it to Congress in September together with the budget proposal for 2000.

The government's reform entailed to increase the VAT rate from the current 10 to 15 per cent – it was the third time Mahuad tried this within twelve months. Another element was to maintain the FTT – at a rate lowered to 0.3 per cent – during the year 2000, after the legislation approved in April had determined this tax would terminate at the end of 1999. The income tax was to be increased with the top rate of both the corporate and personal version of the tax reaching 25 per cent. It was intended that the tax base of the Personal Income Tax would be lowered from the current ECS80 million to 30 million, thereby amplifying the pool of taxpayers significantly (see Table 7.4 for details of the reform proposal). In the light of the continued refusal of the PSC to negotiate any increase of taxes whatsoever even in this time of economic crisis, Mahuad turned again to the smaller parties who had been his allies in April's tax reform. The government negotiated especially with the ID, FRA, DP, PS and MUPP-NP. In the course of their discussions Mahuad had to give up his plan of a 15 per cent VAT given that none of these parties was willing to support the measure. However, for the first time during this governmental term, the opposition became more flexible and was willing to increase this tax somewhat: a consensus was reached on raising VAT to 12 per cent. Yet this concession did not come without conditions attached to it, as Mahuad's allies demanded that the product of this VAT increase would be designated to the municipal governments, which in turn made it easier for them to defend the measure when facing their constituencies. This was against the interest of the executive but they ultimately gave in to this demand.

Regarding the income tax, the top rate of 25 per cent – for both Personal and Corporate Income Tax – as proposed by the government found approval among the parties involved in the negotiations. The aspect they did not agree with, however, was the lowering of the tax base, the lowest level to which they would consent was ECS60 million. There was agreement on keeping the tax on financial transactions, though the opposition parties proposed a rate of around 0.5-0.8 per cent instead of the 0.3 per cent intended by the government. The negotiations about details and percentages carried on for weeks. In mid-October MUPP-NP declared that it would not support the reform; yet without their votes the multi-party alliance around this reform did not represent a majority (*El Comercio*, 20.10.99:7). While the time passed on and still no consensus was found, the media increasingly criticised the inactivity of the Congress and the politicians. The government started negotiating with MUPP-NP in order to bring the party back into the alliance. An agreement was ultimately reached during a discussion in Congress at the end of October (the reform had been sent to Congress almost two months earlier): during a debate, the legislator Raúl Hurtado from the DP summarised the points around which a majority seemed to have evolved and submitted this summary as a document for approval to Congress. His proposal was approved by 51 out of 97 legislators present and then, according to the rules, was sent to the commission responsible for tax matters (*El Comercio*, 27.10.1999). The commission, in turn was only to edit the text, and then re-submit it for the second and final debate to Congress. This procedure speeded up the process as now the differences within the Commission were no longer relevant.

The main elements of the reform which had majority-backing in Congress were: a) VAT of 12 per cent (gains of increase to be passed on to municipal governments); b) FTT to be maintained at 0.8 per cent during 2000, prepayment mechanism kept; c) Income Tax: Personal 5-25 per cent (tax base ECS80 million[128]); Corporate 25 per cent (see Table 7.4).

Table 7.4: Tax Reform November 1999

Original Proposal	Approved Tax Reform
VAT: **15%** (from 10%)	VAT: **12%** (revenues of increase for municipalities)
FTT: **0.3%** (from 1%)	FTT: **0.8%**
Income Tax: a) Personal: **5–25%** (base **ECS30**m) b) Corporate: **25%**	Income Tax: a) Personal: **5–25%** (base **ECS80**m) b) Corporate: **25%**

Source: Own elaboration.

All these elements where approved basically by the alliance the government had managed to form with the ID, FRA, PC, PS and MUPP-NP. However, as regards the increase of the VAT rate, MUPP-NP voted against it thus showing that the government had not managed to come to a deal with this party in the negotiations following

[128] Ca. US$3,200 under the dollarisation exchange rate.

MUPP-NP's announcement to vote against the reform. Yet fortunately for the government the 60 votes reached with the remaining allies (ID, FRA, PC and PS in this matter together with the votes of the ruling DP) were sufficient as only 97 members out of the 125 in total attended the session (*El Comercio*, 27.10.99). The PSC, PRE and MPD voted against all of the issues proposed. However, their voting can be interpreted as a subtle support for the measures: had they abstained instead, the measures would not have been approved, because – according to the Constitution – abstentions are not counted as valid votes and the valid votes (in favour and against) have to reach at least an absolute majority of the members of Congress. Francisco Swett, PSC member and former finance minister, evaluated his party's behaviour in this sense: *"There was an opposition of words but not of deeds."* (Swett, interview, 15.4.2004).

Evaluating the tax reform of November 1999. Comparing the government's original proposal to what was ultimately approved, once again the executive did not manage to get much of its reform proposal through. Great modifications were made given that Mahuad was obliged to form a multi-party alliance in which all of its members had diverse ideas and demanded different concessions. Instead of increasing the VAT to 15 per cent, it was raised to just 12 per cent; instead of the resulting higher revenues benefiting the strained central government finances, these were to be allocated to the municipalities. The tax reform ultimately approved can hardly be called a drastic fiscal measure to counterbalance the deficit. The finance minister at the time, Alfredo Arízaga, considered the increase as an "insufficient" fiscal measure (Arízaga, interview, 31.3.2004). In consequence, the reform can be considered as having failed. Still, some modifications were introduced and after all, it was the first VAT increase since this tax was introduced in 1989 (the Sales Tax, its predecessor, was raised in 1986). It was already the third time that the government had proposed to raise the VAT rate but until now all the opposition parties had refused to consider this. This time, however, they proved more flexible and ultimately did give their support for a 2 per cent increase. The degree of the economic crisis had been perceived by most of the political actors and they were thus more open to accept measures which they would not have accepted at other times. An official of the Internal Revenue Service, Gustavo Guerra, pointed out that there had been a consciousness of the crisis and that it was for this reason that the Congress was more flexible and tolerant (Guerra, interview, 23.3.2004).

Yet legislators were only willing to support the increase given that the revenues would benefit the municipal level, which was against the will of the government and represented a significant further concession. In addition to the greater willingness for taking unpopular measures on the side of the Congress, this tax reform also received much less criticism and protest from popular sectors than was usually the case. When asked how the tax reform was received in the society, Minister of Finance Arízaga described the reaction as: *"A reaction that was rather lukewarm,..., I believe that at the end of the day the citizenry also thought that there was a serious problem with the oil price at this level."* (Arízaga, interview, 31.3.2004). Complementing the support (or lack of protest) the reform enjoyed both in Congress and society, also the economic sectors stated their approval of the measures. During the discussion in the legislature, various Chambers of Production sent a joint letter to the head of state and of Congress expressing their approval of a VAT increase to 12 per cent (*El Comercio*, 8.10.99:8). As mentioned, external influence seems to have played some role in putting the VAT increase to 15 per cent on the agenda - as the IMF made it a condition for granting a stand-by agreement to Ecuador in autumn 1999. Since this increase did not get through, external influence was limited as regards this tax reform.

The End of Mahuad's Government

At the end of 1999 the government still had not managed to find a way out of the economic crisis and no agreement with the IMF – which would have allowed a new inflow of money – had been reached. Mahuad's popularity had been decreasing during the year mainly because of the way he dealt with the banking crisis where he used large amounts of public funds for bailing out banks and during which many people lost their savings. A further blow to his popularity occurred in October 1999 when it was publicised that he had links with Fernando Aspiazu, the owner of one of Ecuador's main banks, the *Banco del Progreso* and who was imprisoned during summer of that year for tax fraud (Paredes, interview, 7.4.2004). Aspiazu announced that he had contributed around US$3 million towards Mahuad's election campaign. When on the 9th of January, President Mahuad announced the dollarisation of the Ecuadorian economy, this measure was the last straw. Thousands of people took to the streets to protest this measure and the government of Mahuad more generally; on the 11th of January a "Parliament of the People" was created, CONAIE, the umbrella organisation of the indigenous movement, called for a national strike, and on the 19th of January around 10,000 protesters gathered in Quito. On the 21st the army general, Lucio Gutiérrez, the President of the CONAIE, Antonio Vargas, and the former President of the Supreme Court of Justice, Carlos Solórzano, took over the presidential palace and installed themselves as the so-called government of "National Salvation". After a few hours of intensive discussions and heavy external pressure the coup d'etat was aborted, the three leaders stood down and Vice-president Gustavo Noboa was sworn in as Ecuador's new President.

7.2 ONE STEP FORWARD – TWO STEPS BACK: TAX REFORM UNDER NOBOA (2000-2003)

In January 2000 Vice-president Gustavo Noboa, a political independent and former university director, succeeded Mahuad and took office as President. Since no new elections had taken place the Congress was still essentially composed as elected in 1998 (see Figure 7.1). The biggest change was a split in the DP whereby 13 out of the 32 DP members separated from the party and formed the MIN (*Movimiento Independiente Nacional*) after the fall of Mahuad. The MIN was the only party supporting President Noboa on an almost permanent basis and declared itself as governmental party. Noboa's economic policies differed very little from those of his predecessor: he continued with dollarisation, enhanced privatisation plans and increased efforts to come to an agreement with the IMF. During his first year of government Noboa set out to introduce two significant pieces of legislation: the Law of Economic Transformation and the Law of Investment Promotion and Citizen Participation, both better known as "Trole I and II".[129]

The first law (March 2000) introduced the necessary legislation and constitutional changes for dollarisation; the second statute (August 2000), contained reforms of the labour markets and paved the way for extending the privatisation of state enterprises. The first law was approved relatively swiftly in Congress where President Noboa was able to count on the support of the DP (ex-party of Mahuad) and the PSC who agreed with the economic measures taken; for the second one Noboa could not gather a majority as the legislature was heavily opposed. However, *Trole II* came into force by default as Congress was involved in another discussion and did not manage to deal with the bill within the 30 days given; not wanting to act in such a blatant way against the Congress, Noboa decided to amend parts of the law and sent another version, the so-called *Trole III*, which watered down the previous bill on several issues. The legislature, however, still greatly modified the legislation before approving it, in response to which Noboa vetoed the bill. Technically, *Trole II* was now valid. Yet in December of 2000, the Constitutional Tribunal declared large parts of this legislation unconstitutional (for

[129] They were named "Trolley Laws" after a trolley bus recently introduced as a new form of public transport in Quito. The analogy being that these laws have many elements, like the trolley has many carriages, and because they were processed on a fast track.

example, restrictions on foreign investment in the hydrocarbons sector lifted by *Trole II* were re-established) and Noboa had thus failed with his project to a large extent. This pattern was to be almost exactly repeated in 2001 when the President attempted to increase the VAT rate.

In late December Noboa introduced some austerity measures: a 100 per cent price increase on cooking gas, a 75 per cent increase of price for public transportation, and increase of petrol prices. This triggered huge protests mainly by the indigenous, peasant and social movements taking place during January 2001. The situation escalated in early February when a state of emergency was declared during which it came to clashes between police and protesters. After a few days, however, an agreement was reached between the government and the indigenous movement and the conflict was resolved.

Attempt to Increase the VAT

"The last reform was a disaster."
Elsa de Mena[130]

Original proposal. On entering the second year of his presidency Noboa started planning a fiscal reform and in early March submitted a bill to Congress – as an urgent economic reform law – to introduce some changes to the tax system. The government's proposal contained the following elements: a) VAT was to increase to 15 per cent from the prevailing 12 per cent; b) Corporate and Personal Income Tax (top rate) were lowered to 20 per cent; c) the SRI was supposed to take responsibility for running the customs (see Table 7.6). During the first debate in Congress (20th of March) basically all parties represented in Congress rejected the main element of the reform which was the increase of the VAT rate to 15 per cent. It was only the MIN which announced it would support this measure. After a defeat of the VAT increase became more and more probable, the government brought forth a compromise proposal hoping they would be able to find allies for it. VAT was now suggested to rise to 14 per cent only and would be lowered to 13 per cent from the following year. However, even this altered version did not convince any of the opposition parties in Congress who ratified their rejection of a higher VAT rate.

When the second (and decisive) debate was held in the legislature during the 28th, 29th and 30th of March three reports were issued by the legislative commission responsible,

[130] Director of Internal Revenue Service (SRI). De Mena, interview, 20.4.2004.

the Commission for Tax, Fiscal, Banking, and Budget Matters: a majority report supported by the DP and ID, and two minority reports by the PSC and PRE. None of these reports proposed a VAT increase to the legislature. While the situation of having two or more reports from this legislative commission (which has seven members) has occurred frequently, the fact that none of these reports (not even a minority one) supported the main element of the government's tax reform proposal is unusual. However, because Noboa was a political independent this situation was possible.

Reform rejected by Congress. When on the 30th of March the bill was voted upon, the government's proposal failed. *El Comercio* (30.3.2001:1) commented this outcome with the headline "*Taxes: Noboa Loses the Battle*". The increase of the VAT rate to 15 per cent (which was still the official proposal) was rejected by 86 votes against the measure and only eight in its favour (from the MIN). The lowering of the income tax did not pass either. The policy to have the customs being taken over by the Internal Revenue Service did not even reach the stage of being voted upon: several parties – the PSC, the PRE and even the otherwise government-supportive MIN – questioned the constitutionality of this proposal and argued that an urgent economic reform law could only make changes to ordinary laws and not to organic laws. The parties mentioned made the case that the measure would require modifications to the organic laws on customs and could thus not be proceeded with. The motion put forward on this was carried and thus a major element was stripped from the reform proposal even before it came to voting. Several elements of the tax reform, though not of the same significance, were approved, however. Among them: a 10 per cent Tax on Public Events; a tax on vehicles; a modification in the salary scheme of Personal Income Tax. When asked why the tax reform failed, Noboa's economic adviser and former Vice-minister of Finance, Alonso Perez-Kakabadse, maintained:

"The Congress of course does not want to get the political blame, so they said no. They accepted most of the reform but not the VAT because that would involve a great political cost." (Perez-Kakabadse, interview, 3.12.2004)

Partial veto. After the main elements of the tax reform developed by the executive had been blocked by the legislature, Noboa's government announced to use a partial veto, which the President carried out only few days after the decision in Congress (date of the veto 9.4.2001). While not objecting to all modified parts for strategic reasons, President Noboa used this instrument to put a crucial element of the original plan back in: the VAT rate was to increase to 14 per cent (not 15 per cent as it was provided for in the original proposal), apparently the government thought the lower rate would provoke less opposition. After the partial veto was announced the Congress had 30 days to either agree to the elements changed by the partial veto for which a simple majority of the legislators present was required, or alternatively to ratify the version originally approved by the Congress. For the latter, however, two thirds of the total members of Congress (82 votes) were needed (Constitution, Art. 153). Overriding a partial veto was thus rather difficult especially when considering that usually not all members were present at the sessions. Before it came to voting on the partial veto, President Noboa visited the Congress to try and convince the legislators of the importance of this tax reform. When defending the increase in the VAT rate he argued:

"Voting negatively on the veto sent would mean a rupture with the IMF and the loss of a loan of US$150m in support of the monetary reserve; the same amount of loans from the World Bank; of US$120m from the IDB; the rupture with the Paris Club and the loss of social projects worth US$300m which had been agreed with the governments of the Club; the loss of the Financial Protocol with Spain for US$420m." (President Noboa, *El Comercio* 29.4.2001:2)

In this speech and at other times Noboa mainly used this argument of the rupture with the multilateral agencies and the loss of income that went with it to explain why increasing the VAT rate was necessary. He thus outlined possible consequences but never really clarified why a higher VAT rate was a necessary measure for Ecuador per se. He made no reference to why the economic situation required an increase or mentioned technical arguments for this measure, he only referred to potential consequences and thus implicitly communicated that the VAT rise was something demanded by external agents. A day after the speech all main parties in Congress – DP, ID, PRE, PSC, MIN and MUPP-NP – confirmed that they would continue to oppose increasing the VAT. By then the Internal Revenue Service had published new figures which showed that tax collection as regards the VAT had improved by 78.7 per cent during the first trimester of 2001 in comparison to the same period in 2000 (*El Comercio*, 1.5.2001:1). Many of the politicians in Congress used this as an argument that an increase in the VAT rate was not actually necessary for achieving higher collections.

VAT increase goes ahead. Before the decision on the partial veto was taken, the media reported repeatedly about the government's attempts to convince legislators from various parties – mainly the PRE, some from the DP and ID – to either abstain during the elections or just to be absent. The strategy was to spoil the opposition's chances to gather the 82 votes necessary for overriding the veto. When the vote was taken on the 2nd of May, the opposition did indeed not manage to mobilise sufficient votes as only 78 legislators voted against the VAT increase to 14 per cent. The opposition had thought they would definitely overturn the veto and was consequently rather surprised by the result, one legislator called for a rectification and the vote was repeated. However, this time even less votes were achieved: 76. It was reported that 14 out of the 22 legislators of the PRE had either abstained or were not present even though the party leadership had confirmed a number of times that the PRE would vote against the VAT rise. Party leader Victor Hugo Sicouret even announced that any PRE member who would not attend the session would be sanctioned with expulsion from the party (*El Comercio*, 3.5.2001:3). Similarly, several DP and ID members were absent. These missing votes together with 11 votes from the government-supportive MIN and those of some independents in favour were sufficient to make the attempt to override the veto fail.

Pork-barrel(ing). The *Democracia Popular* subsequently went ahead and – only days after the vote – expelled its four members who had not followed the party line in this issue. It was generally assumed that these legislators had received some benefits from the government in exchange for the votes (or rather their physical absence). The leader of the congressional party DP, Raul Hurtado, practically stated that the members of his party had entered a deal with the government. When asked if legislators had been "bought" in the debate on the VAT, he answered:

"The five legislators of the DP who did not vote against the VAT increase on the 2nd of May, went to Carondelet (presidential palace, SL) *in the morning of that day. Draw the conclusion yourself."* (*El Comercio*, 10.5.2001:3)[131]

The 14 PRE legislators tried to explain their behaviour arguing that they did not want to join the game directed by the PSC (who had been the main opposition party and the only one who was unified in its vote against the VAT increase) whom they considered as being the cause of the economic crisis Ecuador was facing. While this not particularly convincing argument was presented as the official reason it was widely believed that there had been some deal between the government and the PRE legislators regarding the possibility for a return of their leader Bucaram. Ever since the ex-president went into exile in Panama, the party has tried to strike a deal for him to be able to return to Ecuador without being imprisoned. The widely-held belief that there had been a deal which ultimately allowed the partial veto to go through (the 14 PRE votes were crucial, had they voted against the veto as they had always announced, the 82 votes needed for overriding it would have been easily achieved) was later on

[131] It is not known what benefits the DP legislators received from the government.

confirmed: in late July President Noboa issued a decree which would allow convicted ex-presidents to return to Ecuador and complete their sentence under house arrest (see *El Comercio*, various issues; EIU, August 2001).

Only two former presidents were living in exile: Bucaram and Mahuad. Bucaram was still considered to be the leader of his party (the PRE), and was keen on returning to Ecuadorian politics and, ideally, stand again as candidate for the presidency. Since this was not the case for Mahuad, the decree, allowing Bucaram to lead the PRE from home (though not giving him permission to stand for elections himself), seemed designed for him. Generalising the decree to give this right to all former presidents can be considered a rather feeble attempt of disguise. The obvious link between the vote on the partial veto in May and this decree issued in July was widely made and commented upon in the media though – of course – denied by the government. After the decree was published, Rodrigo Paz from the DP and former mayor of Quito commented:

"(Noboa, SL) *appears absolutely virginal in the way he deals with the Congress: he says he did not buy legislators and now we see that he is fulfilling a pact with Bucaram."* (*El Comercio*, 6.8.2001:2).

The measure received much criticism and was subsequently withdrawn by the Constitutional Tribunal as it violated the principle of treating citizens equally before the law. Apart from the PRE and the DP legislators (plus the three ID ones) who facilitated the passage of the 14 per cent VAT bill by their absence, the MIN was the third party in this round. The legislators of the MIN also received some benefits for their partisan support in Congress. Newspapers reported that some public offices were reshuffled and MIN members appointed to them in the aftermath of the tax reform episode (*El Comercio*, 8.7.2001:3).[132]

Unconstitutional – or According to the Rules?

Yet the opposition did not want to submit to the failure and made huge efforts to have the VAT rate remain as it was. A few days after the vote one legislator from the DP, Ramiro Rivera, presented a motion for the reconsideration of the vote. The two-thirds required by the Constitution for this procedure were achieved (79 out of 116 legislators present voted for it) and another vote was permitted on the VAT increase. Subsequently the Congress voted again on the partial veto on the VAT rate and it was asked for the agreement to the provision of the partial veto (VAT 14 per cent). The result was 73

[132] The son of the MIN legislator Fulton Serrano was appointed as governor of the province El Oro and another relative was put in charge of the Provincial Health Management (*El Comercio*, 8.7.2001:3).

votes against, none in favour and thus fell short of the 82 votes needed for an over-ride (*El Comercio*, 9.5.2001:3). According to the Constitution the partial veto would be enforced and the VAT consequently increased to 14 per cent. As Article 153 of the Constitution (1998) provides:

"...If the veto is partial, the Congress has to examine it within 30 days counted from the day the presidential veto was submitted and can, in a single debate, agree to it and amend the project, with the favourable vote of the majority of people attending the session. It can also ratify the project initially approved with the vote of two-thirds of its members. In both cases, the Congress is to send the law to the Official Register for its promulgation. If the Congress does not consider the veto within the period assigned, it is understood that it has agreed to it and the President of the Republic stipulates the promulgation of the law in the Official Register..." (My translation)

What had happened in this case is that the Congress had neither agreed to the project as proposed by the partial veto, nor had it ratified the law originally approved. The Congress had thus failed to pronounce itself on the issue and the text of the partial veto would come into force by default. However, it can also be considered that the Constitution is slightly vague on this point as it basically gives the options of: a) agreeing with the veto, b) rejecting the veto, or c) not considering the veto. Strictly speaking the Congress had done none of the three in this situation. Noboa's Minister of Government and former representative of Quito's Chamber of Commerce, Marcelo Merlo, considered that there was a legal vacuum which triggered the situation that the President considered the measure was approved since the Congress had not said anything while other people thought it needed explicit approval. *"There is no clarity on this constitutional norm"*, according to Merlo (Interview, 22.4.2004).

The situation that ensued after the vote in Congress and the debate about the partial veto can only be described as constitutional chaos. The legislature sent the version of the law they considered to be the rightful one to the *Registro Oficial* (Official Register, RO): it did not contain the VAT increase to 14 per cent (many legislators had argued after the vote that the VAT increase had been rejected given there had been 73 votes against and none in favour). At the same time the executive interpreted the vote as a failure on the part of Congress to override the veto and itself sent a version to the *Registro Oficial* insisting on the 14 per cent VAT rate. This caused the rather novel situation that two versions of the same law were published in the *Registro Oficial* (*Ley* 2001-41, 14.5.2001). The presidential version was enforced for the time being and the Internal Revenue Service started charging VAT at 14 per cent as from 1 June, 2001.[133]

Table 7.5: Tax Reform 2001

Original Proposal (1.3.2001)	Reform Approved (30.3.2001)	Partial Veto (9.4.2001)	Vote on Partial Veto (5.-8.5.2001)
VAT 15% (from 12%)	Rejected	VAT to 14%	Attempt to override veto failed
Income Tax rate 20% (from 25%)	Rejected		
SRI in charge of customs	Eliminated		

Source: Own elaboration.

The Constitutional Tribunal and arguments for unconstitutionality. The *Coordinadora de Movimientos Sociales* (Coordinating Committee of Social Movements, CMS) announced in mid-May that it would present an appeal to the Constitutional Tribunal asking it to declare President Noboa's partial veto unconstitutional. Their main argument was that the President violated the law by vetoing something that had not been approved by the Congress in the first place. Vetoes could only be pronounced on what had been approved by the legislature (*El Comercio*, 4.5., 15.5., 16.5.2001). The PSC, who later also handed in a case to the Constitutional Tribunal, accused the President of unconstitutional behaviour for the same reason, as the following statement of Xavier Neira (current leader of the PSC and ex-legislator) showed:

"A veto can only be placed on the parts of the law that have been approved. The President cannot incorporate subjects into the partial veto which have not been treated in the law and even worse it is not possible to try and reintroduce subjects which in the debate had been explicitly rejected by the National Congress as it occurred in the case about which we are talking, the increase of the VAT from 12 to 14 per cent." (Neira, interview, 16.4.2004)

Several other people concurred with this interpretation of the Constitution, for example Gustavo Arteta, Director of the think tank CORDES. He explained that since the Congress did not approve anything related to the VAT the President could not actually veto anything. Had it been the case that the Congress had somehow stated that the VAT rate would remain at 12 per cent, the President could have vetoed it and put back his original proposal of the VAT increase. Additionally, Noboa did not even simply put in

[133] It would be worth exploring the role of the SRI in this case and to what extent they took a political stance when deciding to apply the version of the law which included the VAT increase.

his original proposal – which was a VAT of 15 per cent – but changed it to 14 per cent. By doing so he sent a new proposal which Arteta considered as sending almost a new law (Arteta, interview, 7.4.2004). Constitutionalist Antonio Rodriguez accused Noboa of disrespecting the norms by proceeding as he did and pronouncing himself on the rejected instead of the parts approved (*El Comercio*, 13.5.2001:C2). Following the CMS, the *Frente Popular* (Popular Front) equally handed in an appeal of unconstitutional procedure using the same argument as the social movements but also claiming that the President had arrogated himself functions he did not possess by sending his texts for publication to the *Registro Oficial* (*El Comercio*, 15.5.2001:1+3). Thirdly, also the PSC submitted a demand to the Constitutional Tribunal using similar arguments as the first two arguing that the executive made a procedural mistake as it could not promulgate a text via an official letter but only by a decree-law. (*El Comercio*, 18.5.2001:3). This position was shared by the PSC member and former President of the legislative commission responsible for tax matters Simón Bustamante, who said in an interview:

"(The President, SL) *commits an unconstitutional act; the Congress had already sent the law to the* Registro Oficial *and here ends the procedure. The President comes and sends another letter to the* Registro Oficial *insisting in the four vetoes. This is unconstitutional."* (Bustamante, interview, 20.4.2004)

Tax expert Wilson Ruales from the SRI considered that President Noboa had committed an *"unpardonable error"* when sending a letter to the *Registro Oficial*. In doing so he did not use the appropriate mechanism for getting his proposal through as the Constitution outlines that – in case the Congress neither agreed to the veto nor rejected it as Ruales thought was the case here – the President should formulate a decree-law and send it for promulgation to the *Registro Oficial* (Ruales, interview, 23.3.2004). President Noboa thus seems to have made a procedural mistake that could have been avoided easily. To summarise, several groups went to the Constitutional Tribunal with an appeal of unconstitutional behaviour by the President. Various arguments were used and different interpretations of what exactly had been unconstitutional existed: a) the president cannot veto what was not approved in the first place; b) the president cannot send a text that differs from his original proposal; c) the president made a procedural mistake when sending a letter to the *Registro Oficial*.

It is not within the scope of this work to analyse which is the right position and which – if any – procedure was unconstitutional. Yet this case shows clearly that there is a great uncertainty about some constitutional provisions. However, the situation was ultimately caused by the fact that the Noboa government basically had no partisan support in

Congress. Had a majority of the legislature somehow consented to the content of the veto, it is likely it would have just passed even if certain procedural mistakes had been made. Francisco Swett, Ex-finance minister and Central Bank President, evaluated the reactions to the partial veto and the accusations of unconstitutional behaviour:

*"If the political will would have been to raise (*the VAT, SL*) from 12 to 14 per cent, one can be sure it would have passed from 12 to 14 per cent and they would have found the legal reasons to do so... It was a political movement which had its legal base. However, these situations are never black and white. It depends on who has the majority and who has the political power. And usually who tries to raise taxes is in the defensive. Usually it is like this and even more so in the case of the government of Gustavo Noboa which was legislatively impotent."* (Swett, interview, 15.4.2004)

Decision of the Constitutional Tribunal. After the different demands from the Popular Front, the CMS and the PSC were handed in to the Constitutional Tribunal the usual procedure took its course and the discussion within the Tribunal lasted several weeks. The Tribunal consisted of nine members which had been appointed by the Congress. It is widely held in Ecuador that the Constitutional Tribunal is largely a politicised body and people can usually allocate a party label to all of its members. When it came to taking a decision on this issue in early August the vote resulted in a draw: four members voted that the VAT increase was unconstitutional and four claimed it was constitutional. The ninth member of the body – a deputy to another member absent at that time – said he was not sufficiently informed about the case and asked for the vote to be postponed until the following week. The result reflected the dynamics and alliances there had been in Congress on this issue where it was mainly the PSC and the ID who led the opposition bloc against the tax reform. In the space of the Constitutional Tribunal the four members voting for unconstitutional procedure were partisans of the ID, PSC and the PSE, while the ones defending President Noboa's position were related to the DP, the PRE and an independent (*El Comercio*, 3.8.2001:8).

The day after this vote, Noboa's government publicised that since the five votes necessary had not been achieved, the claim of unconstitutionality had been rejected. As the rules did not allow a second vote on the same issue the matter was therefore settled and the VAT rate of 14 per cent would be maintained (*El Comercio*, 4.8.2001:B4). The Constitutional Tribunal, however, had a different understanding of the rules. Its President, Marco Morales, asserted that to reject or approve a matter five votes were necessary. Since these five votes were not reached for either rejection or approval, nothing had been resolved and a new vote was necessary (*El Comercio*, 4.8.2001:B4). Consequently, some days later a new vote took place, which resulted in five votes in favour of declaring the VAT increase unconstitutional as in the meantime the deputy member had made up his mind this way. With this decision the tribunal declared that the partial veto and its subsequent publication in the *Registro Oficial* were unconstitutional and would be withdrawn. As a result the VAT increase, which had come into effect in May that year, was unconstitutional and would be reversed again to its previous rate of 12 per cent. In his first reaction President Noboa declared that he would not accept the recent decision of the Constitutional Tribunal maintaining the position that the vote had already been taken. He announced that the VAT would continue to be charged at 14 per cent (*El Comercio*, 8.8.2001:3). A few days later, however, the President revised his previous stance and accepted the decision. Insisting in his interpretation would have meant challenging the highest-decision making body on constitutional matters and putting the democratic system in danger. Noboa announced that the VAT would be lowered again to 12 per cent as of 1 September, 2001.

Table 7.6: VAT Rates during 2001

Until 1 June		1 June		7 August		1 September
VAT 12%	⇒	VAT 14%	⇒	Constitutional Tribunal: *"VAT rise unconstitutional"*	⇒	VAT 12%

Source: Own elaboration.

Politicised Constitutional Tribunal. What is striking about the discussion is the fact that hardly any legal arguments as to why the procedure breached the Constitution and which particular process was unconstitutional were made either during the discussion or when the decision of the Constitutional Tribunal was announced. The discussion had boiled down to the political argument of being against or for the VAT increase. Economist Pablo L. Paredes analysed the reasons for the decision taken by the tribunal:

"Obviously it was the political pressure. The Constitutional Tribunal never takes decisions for legal reasons; the Constitutional Tribunal is clearly political. You can say "here are the members of the Constitutional Tribunal: this one is Socialcristiano, this one is Socialcristiano, this one is from the ID" – everyone has his label. Consequently, the important decisions of the Tribunal are political not legal." (Paredes, interview, 7.4.2004)

As stated at the beginning, the Constitutional Tribunal is widely held as a politicised body in the Ecuadorian society; a view which was confirmed and described by several interview partners (Interviews, Carrera, Corral, Guerra, Hurtado, Morillo, Paredes, Sandoval, Swett, for dates see Appendix B). In recent years the Tribunal has taken on a more and more prominent role and has been involved in deciding on legislative matters several times. In December 2000 and October 2001, for example, it declared parts of the earlier mentioned *Trole II* legislation unconstitutional. Analysing the legal system and its influence on economic reform decisions lies beyond the scope of this work and can only be exemplified by the case outlined here. What is striking for this analysis is that the political opposition managed to transfer the space of a decision on the VAT increase after it had failed to stop the measure in Congress. With the Constitutional Tribunal a new veto player appeared and managed to make the tax reform fail.

Why the Reform Failed

Influence of external actors. There had been clearly a significant, if not decisive, influence from the multilateral agencies to put the tax reform on the agenda and to include an increase of the VAT rate to 15 per cent. Already in 2000 the government of Noboa had promised this measure in a stand-by agreement with the IMF (April 2000). In February 2001 Ecuador reached a preliminary agreement with the IMF and Finance Minister Jorge Gallardo called on the Congress to approve the forthcoming tax reform in order to allow the country to access much needed financial resources (*Hoy*, 15.2.2001). Alonso Perez-Kakabadse, former economic adviser to Noboa, pointed out the country's dependency on the IMF at a time when access to the financial markets were cut off; he also maintained that for the stand-by agreement: *"One of the conditions of the IMF, and this has always been a key factor, was to increase VAT."* (Perez-Kakabadse, interview, 3.12.2004). When the tax proposal was put forward, IMF and World Bank representatives made frequent statements on the necessity of a higher VAT rate. In late March the Ecuadorian IMF representative, Jeffrey Franks, published an article in *El Comercio* titled *"Ten Reasons for Raising the VAT"* (22.3.2001:5), some weeks later Guillermo Perry, World Bank representative for Latin America, explained to the Ecuadorian media why the multilateral organisations insisted on this reform. As referred to earlier, President Noboa himself used the pressure of these external actors as an argument. A day before the final debate in Congress the IMF even announced that it would abandon the country if the executive's tax reform would not be approved (a threat they did not carry out). The opposition parties of the left considered the reform proposal to be imposed by the IMF and rejected the VAT increase as a measure against the people (Interview, Paredes, 7.4.2004).

It is thus obvious that external influence was hugely important in the development of the reform. Since the reform failed, however, external factors clearly had no (positive) influence on the decision-making process. When analysing why the tax reform failed, the influence of external actors can thus be largely neglected.

Economic interest groups. There is little evidence of influence by economic interest groups. While business groups and the chambers of commerce from Guayaquil seemed clearly opposed to the tax reform (and most probably fed their rejection into Congress through the PSC), the economic interest groups based in Quito took a different line. Quito's Chamber of Commerce, for example, sent an open letter of support for the VAT increase to the President of the Congress during the debate (*El Comercio*, 29.3.2001:2). Signals were thus mixed.

Popular opposition. Apart from the political parties' opposition in Congress, there was also widespread rejection of the measure (mainly the VAT increase) within society. At the time of the reform round tables between the government and the indigenous movement were in place, which had been set up earlier during the year.[134] The tax reform was an important element of these negotiations and since the government had first proposed the tax reform the indigenous movement had asked the executive to withdraw the project. They repeatedly demanded that the VAT remained unchanged. When the executive handed in the partial veto, the indigenous leaders called off their negotiations with the government to express their protest against this procedure. When the process of involving the Constitutional Tribunal in the decision on the VAT rate was started, it was a representative of society – the CMS – who first handed in an appeal. While it is difficult to measure how much influence popular opposition had in this case, it certainly did play a role and the government of Noboa faced a hostile society with its tax proposal in addition to a hostile Congress. Several interview partners referred to the opposition of the social movements (see, for example, Ruales, interview, 23.3.2004) and former Minister of Finance and President of the Monetary Board, Jaime Morillo Battle, observed that the ultimate rejection of the VAT increase by the Constitutional Tribunal was to a significant extent due to the public rejection of this measure and the fact that there was a widespread opposition expressed by street protests, newspaper coverage and declarations on television (Morillo, interview, 7.4.2004).

Executive-legislative power struggle. When Noboa became Vice-president in 1998 he was the first political independent in this position. Since the 1996 elections people who

[134] Part of the agreement reached between the government and the indigenous movement after the earlier mentioned January 2001 austerity protests provided for the establishment of permanent negotiation tables between the two sides on a number of issues. For more information on this see Lucero, 2001.

were not affiliated to a political party could present themselves as candidates. This enabled Noboa to first be elected to the position as Vice-president and later on to become the first independent President of Ecuador since the country's return to democracy. Given that he had no support base in Congress governing became quite difficult for him, however, and the opposition parties often formed a majority to block his proposals. The composition of Congress remained largely as had been when Mahuad came to power: the legislature was highly fragmented and even for Mahuad governing had been difficult though his ruling party had 28 per cent of the seats. Jaime Carrera, from the *Observatorio de la Política Fiscal* (Observatory of Fiscal Politics), affirmed that this lack of partisan support caused several of Noboa's reform attempts to fail:

"He did not have support for any reform in the Congress, neither for any tax reform nor for any economic reform in general – he tried to privatise the electricity and telecommunications companies or some tax reform, he tried to raise the VAT from 12 to 14 per cent but this was also impossible. That is to say politically he could do almost nothing because he had no political support whatsoever." (Carrera, interview, 29.3.2004)

According to Carrera, Noboa only managed to remain in power because oil prices were high during this period and he was therefore able to counterbalance the fiscal deficit.

Conclusion. The period of Mahuad's government provides several cases of significant changes to the tax system, which were mostly not particularly coherent. They are a good example of an erratic pattern of tax reforms in Ecuador which can be largely explained by the dynamics in Congress.

Table 7.7: Tax Reforms under Mahuad (VAT, FTT and Income Tax)

	November 1998	April 1999	November 1999
Original Proposal	VAT: 14% (from 10%)	VAT: 15%	a) VAT: 15% b) FTT: 0.3% c) Income Tax: 25% top rate
Approved Reform	a) Income Tax abolished b) 1% FTT	a) Income Tax reinstated (15% top rate) b) 1% FTT in 1999 (abolished in 2000)	a) VAT: 12% b) FTT: 0.8% c) Income Tax: 25%

Source: Own elaboration.

Within a single year – between November 1998 and November 1999 – Ecuador abolished its income tax, reintroduced the income tax (both personal and corporate) with a top rate of 15 per cent only half a year later, and put it back to its previous level

(25 per cent). Simultaneously, a tax on financial transactions was introduced in the first reform, abolished in the second one, and the third reform provided for maintaining it. Three times the government tried to increase the VAT rate and three times it failed, though in the third attempt a slight increase to 12 per cent (instead of the proposed 15 per cent) was achieved.

The outcomes of all three reforms show the complexity of having an economic reform approved in a situation where the executive faces a highly fragmented legislature and where coalition-building is extremely difficult. The government of Mahuad was forced to make major concessions to have any reforms approved at all. In the case of the November 1998 tax reform, Mahuad chose to form an alliance with the second biggest party in Congress, which ultimately meant, however, that making concessions and finding a compromise was not sufficient: Mahuad gave up on his original plan completely and adopted the PSC proposal to replace income tax by the FTT. His decision to accept this tax reform instead of trying to negotiate something more similar to the government's ideas can be interpreted as political pragmatism and the government's hope that the PSC would be a long-term ally in Congress. Because that was not the case, for the reforms in April and November 1999 Mahuad changed his approach, built a multi-party alliance and developed a common reform proposal with them. A number of concessions to the demands of the various parties involved were made. The outcome of the dynamics the government of Mahuad faced in Congress was that in all three reforms the executive failed to introduce its original plan; the fact that the Mahuad government managed to have any tax reforms introduced at all was due to President Mahuad's choice to first negotiate a proposal for tax reform and build an alliance around it and only when an acceptable proposal was achieved was this sent to Congress (as was the case in both November 1998 and April 1999). In this his government differed from others who often sent their tax reform proposals to the legislature directly and were then not willing to make concessions when their proposal turned out to be politically unviable (for example Duran Ballén's attempt in 1993, see Chapter 6.3).

Considering that Ecuador experienced its worst economic crisis of the last decades, the tax reforms introduced in an attempt to improve public finances cannot be regarded as far-reaching. "Economic crisis" as a variable thus seems to have had a limited influence on the President's possibilities to introduce economic policies. When Mahuad ultimately did take a radical step – by introducing dollarisation – he triggered political instability and was overthrown soon afterwards.

During the different tax reforms undertaken by Mahuad little public protest occurred; opposition by social movements and other groups was more focused on the price increase of gas and electricity which he introduced at the beginning of his term.

When the tax reform of 2001 was discussed in Congress the lack of political support led to an outright rejection of the reform with the opposition to the VAT increase at its heart. However, this was only the beginning of a power struggle between the executive and the legislature. By using the device of a partial veto President Noboa was stretching the rules in order to overturn the legislature's decision. To prevent the Congress from mobilising the two-thirds majority necessary to overturn the veto the executive apparently made deals with several members of the PRE and some other parties resulting in a vote falling short of the 82 ballots necessary for overriding a veto. This combination of making use of a constitutional provision and extra-constitutional deals with opposition parties allowed the VAT increase to go through and be implemented – for some time. Given the degree of opposition to this measure not only in Congress but also beyond, several parties and groups from outside the formal political system tried to bring the tax increase down by turning to the Constitutional Tribunal which approved the appeals submitted and declared the VAT increase as unconstitutional. Social movements played a crucial role in this process via the *Coordinadora de Movimientos Sociales* (CMS).

The tax reforms introduced or attempted during the governments of Mahuad and Noboa do not support the theory that business groups were the decisive variable. In the cases of the 1999 (II) and the 2001 reform private sector groups did not undertake any major attempts to influence the policies; as regards the 1999 (I) tax measure, private sector group mobilisation failed to stop the bill; and in 1998 there is no evidence that economic interest groups carried out any direct lobbying though the idea to replace the income tax with an FTT possibly originated in this sector. In the more recent tax reforms attempted in Ecuador, external actors were more prominent than they had been until the mid-1990s. In 1998 they actively lobbied in Ecuador against the FTT, while both in 1999 and 2001 a VAT rate of 15% was made part of an IMF stand-by agreement. While external actors thus tried to influence the reforms and helped putting some of them on the agenda, they had no impact on the decision-making process: the FTT was introduced against their will, and the two attempts to increase the VAT failed. Other variables like the internal dynamics of the Congress are more conclusive in the decision-making process for the policies.

The process and fate of the tax reform undertaken by the government of Noboa in 2001 can be explained by the fact that he was not able to find any support for this measure either in Congress or society. There are similarities to the government of Mahuad where the income tax was abolished for half a year and then reinstated (see Section 7.1); under Noboa the VAT rate was increased for only three months and later set again at the previous level. It provides a good example for how the dynamics in Congress have led to an often erratic course of introducing tax reforms in Ecuador.

8 Conclusion: Comparing Ecuador's and Bolivia's Reform Experiences

Having set out to determine under which conditions presidents are able to introduce their economic reforms, the last four chapters have provided a detailed analysis of the politics of tax reform in Ecuador and Bolivia. In this final chapter the experiences will be compared and conclusions drawn.

There is a marked contrast in tax policy-making between Ecuador and Bolivia: In most cases when Ecuadorian presidents attempted to introduce tax reforms during the last two decades these either failed or suffered significant modifications. Yet in Bolivia tax reforms were successfully introduced throughout the 1980s and 1990s. From 2000 onwards, however, tax policy-making became increasingly difficult and the pattern became more similar to that of Ecuador. This analysis will compare the tax reform experiences of Bolivia in its first phase with those in Ecuador; after this inter-country comparison, the two phases of tax policy-making within Bolivia shall be considered.

8.1 How Institutions Helped or Hindered Tax Reform (1980s and 1990s)

Bolivia. During the governments of Paz Estenssoro, Paz Zamora and the first government of Sánchez de Lozada a number of tax reforms were introduced successfully: in 1986, 1990, 1992 and 1994 these were approved just as they had been proposed by the executive (a modification was made to the 1994 one given the pressure of the private sector). They were implemented despite the existence of fierce opposition in several cases. Particularly when the VAT was raised to 13 per cent in 1992 the measure was rejected by several sectors and when a Corporate Income Tax was introduced in 1994, private sector groups lobbied heavily against the rate of 25 per cent that was approved. In all four cases, the tax policies could be introduced due to the existence of a ruling coalition which provided presidents with sufficient partisan support to have the measure approved by Congress. The majority held in Congress, which basically ensured the approval of almost any policy proposed by the executive *ex ante*, also allowed the government to ignore criticism from opposition parties, private sector groups, trade unions or other sectors. Not only did the government coalitions facilitate reforms to be introduced but also allowed that they were maintained. Bolivia's tax system was coherently changed over the years (see Table 8.1 and Appendix G for an overview 1986-2004).

Table 8.1: Tax Reforms in Bolivia – Overview

Year	President	Proposal of Government	Outcome
1986	Paz Estenssoro	Radical overhaul of tax system: over 450 taxes replaced by 7	Approved
1990	Paz Zamora	2% Transactions Tax (from 1%)	Approved
1992		VAT rise to 13% (from 10%)	Approved
1994	Sánchez de Lozada	a) 30% Corporate Income Tax b) 3% Transactions Tax (from 2%)	Approved with slight modification: a) 25% corporate tax; b) approved

Source: Own elaboration.

Ecuador. In Ecuador, by contrast, an increase from 6 to 10 per cent in the Sales Tax was implemented in 1986 and a major reform was successfully introduced in 1989. Apart from these cases, however, all subsequent tax proposals made by presidents were either outright rejected by Congress (1993, 1998, 1999 (I)), only a minor part of the legislation was approved (1996), or the proposal was greatly modified (in 1999 (II)), or another institutional actor made the tax bill fail (as was the case in 2001 when the Constitutional Tribunal declared the VAT rise unconstitutional). In short, in all these cases – except the 1986 and 1989 reform – presidents were unable to introduce their policy proposals as they intended. All these tax reforms were attempted by minority governments and in no case were presidents able to count on or gather sufficient partisan support for their tax laws. This inability of presidents to introduce their policies resulted in a rather erratic pattern of taxation in Ecuador: examples of this occurred during the government of Mahuad, when in 1998 income tax was replaced by a tax on financial transactions and the income tax was re-introduced only half a year later; or in 2001 under Noboa when the VAT was increased to 14 per cent and lowered again to 12 per cent after only three months of being in force.

As the Tables 8.1 and 8.2 show there was an overall pattern that while in Bolivia wide-ranging reforms to the tax system were usually approved, most reform attempts in Ecuador were rejected or greatly modified. While aspects such as pressure from the private sector or external influence were rather similar in the two countries, the major difference between them was that a majority coalition approving reforms in Congress existed in Bolivia but was absent in Ecuador. Several institutional aspects contributed to causing this difference.

Table 8.2: Tax Reforms in Ecuador – Overview

Year	President	Proposal of Government	Outcome
1986	Febres Cordero	Sales Tax 10% (from 6%)	Approved (by default)
1989	Borja	Overhaul of tax system. Many small taxes abolished.	Approved
1993	Durán Ballén	a) VAT 18% (from 10%) b) Reducing VAT exemptions c) Raise excise taxes	Rejected
1996	Bucaram	a) Excise tax increase b) 2% on cars c) Elimination of VAT exemptions d) Corporate tax 20% (from 25%)	All but d) rejected
1998	Mahuad	VAT 14% (from 10%)	Rejected
1999 (I)		VAT 15% (from 10%)	Rejected
1999 (II)		VAT 15% (from 10%)	Modified (VAT 12%)
2001	Noboa	VAT 14% (from 12%)	Rejected

Source: Own elaboration.

Plenario. Analysing Ecuador's tax reform of 1989 it turned out that the reform passed without modifications due to the "institutional oddity" of the Ecuadorian system, which allowed the *Plenario* to decide on legislation (see Chapter 2.4). Given that the *Plenario* was not required to be proportional to the representation in Congress, the ruling party had a majority in this proxy body, which it did not hold in the full Congress. The possibility of having the tax bill approved in this legislative space rather than in the Congress thus allowed President Borja to pass his reform without any modifications (see Chapter 6.2). In later reform attempts this possibility did not have similar effects on tax policy-making given that after Borja no other government held a majority in the *Plenario* (Borja had achieved this since he was close to holding a majority in the Congress as well; he held the highest number of seats in Congress of all ruling parties since Ecuador's return to democracy). With the new Constitution of 1998 the *Plenario* was deprived of its right and since then it needs to be the full Congress approving legislation.

Decree power. In Chapter 2.2 Ecuadorian presidents were described as having rather strong decree powers. Did these make any difference to presidents' attempts to introduce tax reforms? In one case they did lead to the introduction of a bill which would otherwise have been difficult: in 1986 President Febres Cordero managed to have the rate of the Sales Tax increased from 6 to 10 per cent. The law was sent – as one of many reform proposals – as "urgent" which meant that the legislature had only 15 days to decide on them. Given the amount of bills received the Congress simply did not manage to discuss all of them and the tax reform was one of those that came into force by default. Later on this practice of sending more than one bill at a time was prohibited and decree power became less important. It continued to have the effect that Congress had no possibility to delay the discussion and a decision on tax reforms was thus usually taken within one month. Yet it did not help presidents introduce their proposals since they were not able to simply decree as Congress was allowed to vote on the bills (if they managed in the time given).

Veto power. Ecuador's presidents also enjoyed the power of veto but made little use of it for tax or other economic policies over the last two decades. In 1999 Mahuad managed to change the reform somewhat by using a partial veto (a part of it was overturned by Congress though) and in the case of the attempted VAT increase in 2001, President Noboa used a partial veto after the Congress had rejected his proposal. Though there was a near consensus against the reform, the legislature did not manage to mobilise the two-thirds of the votes necessary to overturn the veto (essentially because Noboa had made a deal with the PRE regarding the return of Bucaram so that the PRE legislators abstained in the vote). The VAT rate was increased and it looked for a while as if the veto had been a powerful instrument that had allowed the President to introduce the reform. Given, however, that Noboa did not have a majority of the parties represented in Congress behind him, the opposition managed to transfer this clash between executive and legislature to another level. The Constitutional Tribunal – which mirrored the power relationship of the parties in Congress – declared the VAT increase to be unconstitutional and its introduction was reversed. While it can be argued that there had been procedural mistakes in the way the veto was used, it was clear that the decision of the Constitutional Tribunal was a reiteration of the legislature's rejection of the bill. Had a majority in Congress been in favour of a higher VAT rate, the Constitutional Tribunal would most probably not have found any fault with the procedure of the veto.

Emergency power. The possibility to declare a state of emergency was taken advantage of by several Bolivian presidents and generally resulted in greatly diminished public protests against economic reforms. It most notably had an influence on the Bolivian tax reform introduced in 1986 during the government of Paz Estenssoro. He made use of his constitutional power to declare a state of emergency several times during his term between 1985 and 1989, which helped to significantly reduce the opposition and mobilisation potential of trade unions (particularly the COB). The thus limited public protests against the tax reform of 1986 facilitated its introduction.

The literature in the field of empirical institutionalism (see Chapters 1.2 and 2.2) has traditionally looked at these constitutional powers of the president – such as decree and veto power – to explain governability. Looking at the cases of Ecuador and Bolivia, however, it has become clear that these powers had only limited influence on presidents' ability to introduce reforms and by themselves cannot account for the differences in policy-making between the two countries.

Coalition-building. Given that the Bolivian system was able to produce coalitions, governability was enhanced and significant reforms to the tax system could be introduced. The various reforms of the 1980s and 1990s outlined in Chapter 4 and 5 were all possible due to the inter-party coalitions existing in Bolivia at the time. In Ecuador, by contrast, the absence of stable coalitions made most tax reform attempts fail, apart from those cases where presidential powers (decree power in 1986) or other institutional aspects (*Plenario* mechanism in 1989) facilitated them. A case has therefore been made that in future institutional analyses of presidential systems, the variable of coalition-building capacity should be integrated. This aspect has previously been neglected given the assumption that presidential systems are unable to form coalitions. In several cases the existence of coalitions has helped presidents to introduce wide-ranging economic reforms just as Paz Estenssoro was able to implement his economic reform programme in 1985 with the help of a ruling coalition. The Bolivian experience can be compared to that of Brazil where in 1995 the Cardoso government managed to introduce a wide-ranging economic reform programme thanks to the coalition in place. While the existence of coalitions can explain the difference between patterns of policy-making in Ecuador and Bolivia, the question is why one country produced coalitions and the other did not. As shown in Chapter 2 both Ecuador and Bolivia have a fragmented multi-party system and share several features regarding electoral procedures, proportional representation, and majority elections. Still, Bolivia formed a pattern of coalition-building since 1985 and Ecuador's coalitions were fragile and short-lived at best. It is argued that the points presented below can explain this phenomenon.

Bolivia. ***Second round election of president.*** In Chapter 2 the procedure surrounding the election of presidents was already outlined: in Bolivia, when it came to a second round during the presidential elections (which was always the case), the president was not chosen by popular vote but by the Congress (choosing between the first two candidates). This electoral procedure provided an incentive for coalitions to be formed to elect the president. Similar to the procedure in parliamentary systems, the president required a positive vote of the Congress to get into power and to form a government. Finding allies to support the election of a president in the second round therefore became necessary and coalition negotiations took place before the elections. These pre-electoral coalitions have then usually carried on and turned into governmental coalitions.

Table 8.3: From Art. 90 to Approval of Tax Reforms

Art. 90 of the Constitution: in case of second round presidents to be elected by Congress
⇩
Provided incentive for coalition-building
⇩
Stable ruling coalitions provided presidents with sufficient partisan support in Congress
⇩
Executive's tax reforms approved by Congress and introduced

Source: Own elaboration.

The pattern of stable coalitions that developed since 1985 lasted until October 2003.[135] The coalitions provided presidents with sufficient partisan support to have their reform proposals approved. Not only were Bolivian presidents able to introduce the tax reforms analysed in this thesis, they generally introduced rather wide-ranging economic policy reforms during this time period. The pattern observed in the case of Bolivia can thus be summarised as in the Table 8.3: presidents were generally able to introduce the tax reforms they proposed because they counted on the support of a ruling coalition in Congress, which in turn was facilitated by the procedure surrounding the second round elections of presidents set out by Article 90 of the Constitution.

[135] It is difficult to establish an exact date here. By October 2003 the pattern had certainly not been stable any longer; yet at this date coalition politics experienced its most intensive crisis.

The importance of electoral rules in bringing about coalitions is underlined when comparing Bolivia to other countries where stable ruling coalitions have been formed. Chile, for example, uses a binominal electoral system in which two seats per district are elected. This creates strong incentives for parties to build electoral coalitions as smaller parties stand no chance of winning one of these two seats. In consequence, the Chilean party system since 1989 has consisted of several parties that are organised in two stable coalitions.

Patronage. While the electoral formula can account for why coalitions come into being in the first place, it is patronage that explains why coalitions last. As Geddes (1994:152) pointed out patronage is the *"glue that holds coalitions together in Latin America"*. As scholars of Bolivia pointed out the coalitions formed were essentially based on patronage payments, usually consisting of public sector positions (see, for example, Gamarra 1997). As was outlined in Chapters 4 and 5, the coalition agreements in Bolivia always entailed a sharing of ministerial and other positions, a procedure which became more and more important over the years. While during the government of Paz Estenssoro (1985-89) it was not yet a major driving force of the coalition, already during the subsequent government of Paz Zamora (1989-93) side payments played a significant role and by the time of the coalition formed under Sánchez de Lozada's second presidency (2002-03) the pact seemed to be glued together by little more than patronage. Presidents also frequently changed the number of cabinet positions so as to accommodate the demands of coalition partners. This happened, for example, in 2003 as Sánchez de Lozada increased the number of ministries from 13 to 15 when the NFR entered the coalition (see Chapter 5.2).

Ideological convergence. As pointed out by Foweraker (1998) lower levels of ideological polarisation make the formation of coalitions more feasible. Accordingly, an aspect that also facilitated coalition-building in Bolivia was that the three main parties – MNR, ADN, and MIR – that dominated the period of coalition politics, had developed rather similar views on the type of economic policies that needed to be introduced (see also Chapter 2.4). A good example is that the reform programme developed by Banzer and his ADN during the election campaign in 1985, had a lot of similarities to what was eventually introduced under the presidency of Paz Estenssoro (MNR). Given that there was agreement on the policy agenda, the formation of coalitions was facilitated by this ideological convergence.

Ecuador. In Ecuador, where the president is elected by popular vote in the second round, the difficulties of governing in the context of a highly fragmented multi-party system have been daunting. The political system provides no incentive similar to Bolivia's for the formation of inter-party coalitions. No executive since the return to democracy in 1979 was able to rely on a stable governmental coalition. The few coalitions that were formed during the last two decades (for example, the coalition between the ID and the DP during the government of Borja lasted just over a year) were generally rather volatile and – more often than not – presidents had to rely on forming ad hoc alliances around specific policy proposals. Informal alliances in which deals were made with a number of legislators occurred, for example, in 2001 as Noboa tried to prevent the Congress from overriding his veto (see Chapter 7.2). This lack of stable partisan support in Congress made the implementation of comprehensive and consistent economic policies difficult: proposals made by reform-minded presidents were often either blocked or significantly watered down. Several aspects can explain the absence of stable coalitions in Ecuador.

Electoral formula. In contrast to Bolivia, Ecuador's electoral formula – majority run-off – provides no incentive for the formation of coalitions as presidents can come to power without a majority vote in Congress. A large number of the Ecuadorian interviewees pointed out that the country's difficulties of governability had to do with the second round election of the president while the deputies are already elected in the first round (Interviews: Acosta; Arízaga; Arteta; Carrera; Corral; de Mena; Hurtado; Minuche; Morillo; Ortiz; Pachano; Ribadeneira; for dates see Appendix B). Former finance Minister Arízaga pointed out:

"One of the great problems of governability which Ecuador has is that the deputies are elected in the first round when there is a large number of candidates to the presidency. This provokes that the president who is finally elected in the second round does not count on a majority in Congress." (Arízaga, interview, 31.3.2004)

Would the deputies, on the other hand, be elected in the second round of the presidential elections the president's party would certainly hold a higher number of seats in Congress which would make governing easier, Arízaga assumed. Apart from this electoral procedure which has contributed to making the president's party count on only a relatively small number of seats in Congress, the situation is aggravated by Ecuador's difficulties of coalition-building.

Patronage. Given that patronage was a crucial aspect to holding coalitions together in Bolivia, the question is why Ecuadorian presidents were not able to use side payments to other parties in a similar way and thereby achieve stable coalitions. The answer lies in the fact that the Ecuadorian system provides a strong disincentive for coalition formation.

Mid-term elections. Until 1998 Ecuador elected a new Congress every two years. On the one hand this had the consequence that during the second half of every president's term their parties saw their representation in Congress greatly reduced and the minority status was aggravated. On the other hand this schedule of biannual elections meant that parties were practically in a permanent election campaign. As mentioned in Chapter 2.7 in Strøm's contribution to coalition theory, he looked at how minority governments come into being. Strøm (1990) argued that minority governments would occur either if parties were able to influence policy-making also while being in the opposition or if being part of a coalition would have adverse effects in future elections. This latter concept of "coalition avoidance" and his related concept of the "negative incumbency effect" apply to the case of Ecuador as parties did not want to be associated with the ruling party especially when elections were approaching. That there is a "negative incumbency effect" becomes easily clear when considering that during the whole time period dealt with here, not once was a ruling party re-elected to power.[136] This pattern differs markedly from Bolivia's where the three main parties – MNR, ADN, and MIR – were re-elected as ruling party or party with the highest number of votes between 1985 and 2002 and where being in power therefore did not have quite as detrimental an effect as in Ecuador. Since elections took place every two years parties often avoided forming part of a coalition altogether as they did not want to mar their electoral prospects. The fact that the DP defected from its coalition agreement with the ID in 1989, is a good example for the "negative incumbency effect" as the DP left in time to be considered a party independent from the ruling ID in the mid-term elections taking place in 1990. Strøm's second aspect to explain why minority governments occur also applies to Ecuador: as the various examples of tax reform show opposition parties do have the possibility to influence policies. Joining the government to have some power over policy decisions is therefore not necessary. In Bolivia by contrast, where the legislature functioned more like a "rubber stamp" (Gamarra, 1994:121) and where policies where

[136] The ruling parties were: 1984 – PSC; 1988 – ID, 1992 – PUR; 1996 – PRE; 1998 – DP; 2002 – MUPP-NP.

generally introduced as proposed by the government, being part of the opposition had few advantages as one was shut out both from access to patronage and from policy decisions.

Apart from providing a disincentive to coalition-building, mid-term elections also had the effect that only during the first two years of the term major economic policy initiatives had any chance of success. Under President Borja (1988-92), for example, tax legislation was introduced in 1989. A second stage of this tax reform was planned yet given the changed circumstances in Congress after the mid-term elections the President did not even send the bill to Congress. During the subsequent governments Durán Ballén (1992-96) attempted to introduce a tax law in the second year of being in power in 1993 and Bucaram (1996-97) proposed a tax reform to Congress after four months of being in government. This pattern of undertaking major economic reforms at the beginning of a president's term is of course not only related to the process of mid-term elections - introducing contentious reforms is easier for any government soon after the elections when popularity rates are still high. While this commonly called *honeymoon* thesis has some explanatory power it has its limits when comparing policy-making in Ecuador and Bolivia. In Bolivia there have been cases when presidents were able to introduce wide-ranging economic reforms also towards the end of their terms given that their support base remained and was uninterrupted by mid-term elections. The tax reform of 1992 when Paz Zamora (1989-93) managed to increase the VAT from 10 to 13 per cent provides a good example.

Ideological Convergence. An ideological consensus around the type of economic policies to be introduced - as had developed in Bolivia among the three main parties – never existed in Ecuador. The policy positions of parties like Borja's ID (in power between 1988-92) or Febres Cordero's PSC (1984-88) clearly differed and co-operating in a coalition would therefore have been extremely difficult for these parties. As Coppedge (1998b:561) showed, Ecuador's party system was significantly more ideologically polarised than Bolivia's. Following Foweraker's argument (1998) mentioned earlier, coalition-building was therefore probably less feasible in Ecuador. Still, in Bolivia also parties with a very different ideological programme joined the coalitions as was the case with both CONDEPA and UCS. Their co-operation had little to do with ideological convergence but was obviously motivated by their desire to access patronage. In short, while Ecuador's higher degree of polarisation (as compared to Bolivia) may have contributed to making coalition-building more difficult, other aspects – such as the electoral formula and the mid-term elections which prevent patronage from acting as a glue – seem more relevant in explaining the differences between the two countries.

Presidential Powers and Vote of Censure. Finally, several other institutional aspects contributed to Ecuador's difficulties of building stable majority coalitions. Given the extensive veto and decree powers granted to presidents an incentive is created for presidents to try and govern without being able to rely on a majority in the Congress. In practice, however, these powers were generally not sufficient for implementing economic reforms. In addition, the provision for the legislature to censure cabinet ministers – which was made ample use of in Ecuador (see Chapter 2.2) – made being part of the ruling coalition and cabinet rather undesirable. Ecuador has the highest cabinet instability in the region, followed by Brazil, Venezuela, and Colombia (Stein et. al., 2005:62). Holding a cabinet post in Ecuador, therefore, was an endeavour that had an uncertain time-span and entailed the risk of undergoing a tedious interpellation procedure convoked by the Congress. Cabinet positions are generally important patronage material offered to allies in exchange for their support as had been the case in Bolivia. Since Ecuadorian presidents were unable to grant the positions for the full governmental period – as ministers could be censured at any point by the Congress – their value and attractiveness was reduced.

The first finding of the research undertaken can consequently be summarised as follows: when considering under which conditions presidents are able to introduce economic reforms of their choice, institutions do matter. While the more extensive formal powers granted to Ecuadorian presidents have generally not helped them to introduce policies, particular institutional aspects – such as the *Plenario* and decree powers – facilitated the introduction of reforms in some cases. The capacity to form coalitions turned out to be more important than presidential powers and since Bolivia's political system was able to produce majority governments after 1985 presidents were able to introduce wide-ranging tax reforms in the 1980s and 1990s. Their Ecuadorian counterparts failed to do so due to the lack of institutional incentives for overcoming the political deadlock of a fragmented Congress. The existence of coalitions in Bolivia can be explained by several aspects: Bolivia's coalitions were formed in the first place due to the institutional incentive of electing the president in Congress; they generally remained in place for full governmental periods due to the patronage logic holding them together; and ideological converergence between the three main parties made it easier for them to support each other's governments. In Ecuador, by contrast, the electoral formula provided no incentive for coalition-building; the recourse to patronage to form stable coalitions was weakened by the existence of mid-term elections which meant that avoiding coalitions improved the electoral prospects of parties; and finally, presidential powers and the vote of censure represented other institutional disincentives to the formation of coalitions.

8.2 Alternative Explanations

The argument outlined above largely relies on institutional aspects to explain the process of tax policy-making in Ecuador and Bolivia. In the literature on the politics of economic reforms other approaches have been used which shall be contrasted with the institutional argument in the following.

Interest groups. A common approach applied to explaining policy reforms focuses on the influence of interest groups. Based in the political economy framework, the approach argues that the content of economic reforms can be accounted for by the relative power of interest groups. Jeffry A. Frieden's *"Debt, Development, and Democracy"* (1991) is a crucial work in this theoretical approach. Looking at the varying responses of Argentina, Brazil, Chile, Mexico, and Venezuela to the debt crisis of the 1970s and 1980s, he argued that the economic policies undertaken in that period are the results of economic interest group pressures on policy-makers. Regarding research on the Andean countries, the business sector also played a central role in Conaghan and Malloy's (1994) earlier mentioned analysis (see Chapter 1.2). Also in this thesis economic interest groups are seen as important actors in both countries and their position towards the tax reforms was consequently outlined in the cases analysed. Pressure from the private sector was successful in changing the tax policies studied in only a few cases. On occasion they managed to achieve some concessions but in a significant number of cases their lobbying had no influence whatsoever. Considering Ecuador: for example, in the case of the 1996 reform attempt undertaken by Bucaram, Ecuador's private sector had some influence but was not the only determining factor. The opposition of business groups to increasing excise taxes was successful as the government modified their proposal in response to the pressure. However, in the ultimate decision on the proposal it was the legislature that determined the fate of the reform: the opposition counted on sufficient votes to turn the excise tax increase down but made a strategic mistake by leaving the legislative space and the increase ended up being approved. This episode in the Congress shows the importance of looking at legislative dynamics to explain policy reforms – interest groups alone are not a sufficient explanation. During the government of Mahuad the Financial Transactions Tax was introduced against the interest of not only private sector groups but also economic experts, and the changes to the tax legislation approved by Congress in April 1999 were equally rejected by economic interest groups.

Also in Bolivia interest group pressure similarly sometimes mattered and sometimes not: in the 1986 reform the business sector lobbied for some changes to the proposal but it was approved by the Congress despite the pressure. When the government of Paz Zamora intended to raise the VAT rate in 1992, economic groups started a massive campaign against the increase, yet ultimately failed as the coalition government went ahead introducing the tax reform anyway. In the subsequent reform private sector opposition had some success as the executive agreed to lower the proposed Corporate Income Tax to 25 per cent. However, this was only a partial achievement as the business sector had lobbied for 20 per cent and against the increase of the Transactions Tax to 3 per cent and remained heavily opposed also to the modified version of the legislation approved by the Congress. The attempted excise tax increase in 2000, on the other hand, represents a case where economic interest groups proved decisive: due to their pressure President Banzer agreed to withdraw the measure only a few months after its introduction. Similarly in April 2004 the opposition of business groups based in Santa Cruz managed to have the Net Property Tax dropped. In 2003, however, though private sector groups criticised the government's plans to introduce a Personal Income Tax, it was popular protest that was decisive in leading to the failure of the tax reform.

This summary of the evidence gathered on the influence of Ecuadorian and Bolivian business groups on the tax reforms studied, shows that these groups did have a certain degree of influence in several cases yet this would not be sufficient to explain why reforms happened or failed. Several reforms were introduced despite massive protest and lobbying attempts of economic interest groups – particularly in Bolivia during the time of coalition politics – so they were not the decisive factor.

External influence. A number of scholars have investigated the extent to which external influences have played a role in shaping economic policies. Nelson (1990), Stallings (1992), Kahler (1992) and Weyland (2004), for example, applied an international-level approach and particularly considered how conditionality of multilateral organisations such as the IMF and the World Bank influenced the economic policies introduced by developing countries. Most of these authors, however, while claiming that external factors are important to take into account and often have a significant influence especially as regards agenda-setting, conceded that this explanatory framework has its limits and that domestic explanations are more important particularly when accounting for policy choices. At the non-academic level, however, the pressure and influence of external actors – mainly the IMF and World Bank – is often considered to play a great role in the countries studied.

Considering the cases of tax reforms in Ecuador and Bolivia the limits of this approach become quite clear. In the early reforms undertaken (e.g. 1986 in Bolivia and 1989 in Ecuador) external actors played no role as tax reform would only become part of their agenda in the 1990s. As regards the later reforms they sometimes had an influence on the agenda-setting process but cannot account for the decision-making process where domestic dynamics were decisive. Ecuador's attempt to increase the VAT to 15 per cent in 2001, for example, was clearly influenced by multilateral agencies, as the IMF and World Bank had repeatedly demanded this increase and made it a condition of an IMF stand-by agreement. The reform, however, was not introduced in the end as Ecuador's Constitutional Tribunal declared it unconstitutional. While external influence thus clearly played a role in putting this tax reform on the agenda this factor is unable to account for the outcome as the reform failed due to a domestic actor. Similarly in Bolivia in February 2003: while the multilateral organisations had advocated the introduction of a tax on personal income for several years, it was a domestic decision to propose this tax in that moment. Some pressure had certainly been put on the government as the IMF demanded a reduction of the fiscal deficit in exchange for granting a new credit line to Bolivia. While this provided a broader framework which made fiscal measures necessary, the particular policy chosen cannot be explained solely by referring to external actors. Additionally, since this reform ultimately failed due to popular protest, external influence could have gone no further than setting the agenda. In other cases, the multilateral organisations disagreed with the reforms proposed and tried to prevent them as happened in 1998 when IMF representatives tried to stop the FTT – which was nevertheless was introduced by the Mahuad government. These cases show that external influence by the multilateral organisations sometimes – though not always – played a role in agenda-setting since the mid-1990s but generally had little influence on policy choices as domestic variables were decisive at this stage.

Considering external influence it needs to be pointed out, however, that US influence has certainly played an important role in Bolivia and that this country is much more exposed to US pressure than Ecuador. The US has been able to impose its policies regarding coca eradication for the last two decades and has therefore had an important presence in the country. Some other examples illustrate how the US government has interfered into domestic politics: in 2002 an attempt was made to influence the elections as US ambassador Rocha stated that the USA would withdraw all economic help and would close their markets in case Evo Morales would win the elections (*La Razón*, 27.6.2002:B4). This attempt to interfere into Bolivia's internal affairs did, however, backfire: it seems this statement of the ambassador gave an extra boost to the campaign of Morales who ended up in the second place though he had featured in the third or fourth place only in the polls taken prior to the elections (*Fundación Milenio*, 2002:65-66). However, it can be said that the US government's intention to prevent Evo Morales from coming to power has ultimately worked out. In the run up to the second round elections in Congress the US helped facilitate coalition partners for Gonzalo Sánchez de Lozada so that he would be elected as president. The MIR, which had previously resisted entering the Sánchez de Lozada government, ended up being a coalition partner after an intervention of the US (see Chapter 5.2).

In this and many other ways, therefore, the US government can be said to be an important actor within Bolivian politics (especially in the field of the politics of coca, see Chapter 3.9) and is certainly more present than is the case in Ecuador. However, in important decisions about economic reforms external influence of the US did play a limited role. For example, in the case of the shock programme introduced via Decree 21060 in 1985 this was introduced during a time when the US took little notice of Bolivia (Lynch, 1994a:116). Similarly, in the cases of tax reforms considered in this thesis there is little evidence that the US has been an important actor. Consequently, domestic variables are taken to have played the decisive role in tax politics.

Apart from the two approaches focusing on external actors and interest groups, the role of social movements and the impact of presidents' policy positions on the reform process were also considered in the thesis and shall be analysed here.

Social Movements. No evidence was found that popular protest organised by social movements, trade unions or other groups played a major role in determining Ecuador's and Bolivia's patterns of tax policy-making. In a large number of cases hardly any protests occurred, partly because their opposition was focused on other issues (elimination of subsidies, salary increases) or because they did not consider themselves hugely affected (e.g. corporate income tax bill in 1994 in Bolivia; FTT in 1998 in Ecuador, 2004 in Bolivia). There are, however, significant exceptions: in 2003 the income tax in Bolivia could not be introduced due to popular protest by social movements and other groups; and in 2001 in Ecuador social movements' protest and appeal to the Constitutional Court played a crucial role in reversing the VAT increase. In the course of the 1990s, indigenous and peasant movements appeared on the scene in both countries as important political actors and their influence has increased over time. They have also broadened their policy agenda (e.g. originally focusing mainly on land rights or other issues affecting them) and started challenging the government on various policy levels. The fact that the cases where social movements played an important role in making tax measures fail occurred in recent years, confirms this trend.

The Role of Presidents' Policy Positions. To what extent have the policy positions of the incumbents played a role in presidents' abilities to introduce tax policies? Or, in other words, is there an ideological explanation as to why presidents in Ecuador generally had more difficulties in getting their policies through? In Chapters 4 to 7 a short outline of each president's electoral platform has been given and compared to the policies introduced subsequently. Especially in Ecuador, but also in Bolivia for example in the case of Paz Zamora in 1993, there was often a wide gap between candidates' election campaign pledges and the policies they introduced once in power. As Stokes (2001:111) commented: *"In Ecuador, presidents seem always to do just what they promise in campaigns not to."* In her work Stokes (2001) analysed cases of mandate switching and referred to prominent cases as Peru's Fujimori who announced in his electoral campaign he would not increase prices and once in power raised them massively; or, Venezuela's Andrés Pérez who promised wage increases and then breached this promise. Stokes provided a useful explanation as to why these policy switches occur. Presidents may be convinced that unpopular policies may be more beneficial economically (and ultimately thus for themselves politically). Yet lobbying on a platform of unpopular policies would rule out any chances of being elected. Consequently, as Stokes argued, many presidents adopted the strategy to lobby on a "security-oriented platform" and once in power switched to an "efficiency-oriented" agenda and implemented market-oriented policies. Febres Cordero's (1984-88) and Durán Ballén's governments (1992-96) provide good examples for this approach as both of them toned down their neoliberal discourse during the campaign to increase their chances of being elected. Yet while in these cases politicians from the right undertook a mandate switch, in Bolivia a left-wing politician changed his course as happened in 1989 with Paz Zamora. Stokes' approach argued that policy switches were more likely when presidents are in minority or coalition situations as they would need to make concessions to other parties. The special situation of Paz Zamora who was elected president despite being only the third most-voted candidate who then entered in a coalition with a party that held a lot more seats can largely explain the mandate switch.

While Stokes' work is helpful when trying to explain why policy switches occur, it provides little evidence for explaining how they influenced presidents' policy-making records. Do mandate switches make the subsequent introduction of market-oriented policies more difficult? The most prominent case of a policy switch in Ecuador was the u-turn Bucaram undertook when elected in 1996: after promising all sorts of social improvements in his campaign he quickly went on to announce one of the most orthodox agendas ever proposed in Ecuador when entering office. Though his party programme was committed to lowering the tax burden of the popular sectors, the first reform he undertook would have increased taxation significantly. Bucaram failed, however, to get this tax bill through Congress (see Chapter 6.4). Sánchez de Lozada's attempt to introduce an income tax in 2003 also supports the claim that mandate switches make introducing policies more difficult. Though he had promised to lower tax rates in his election campaign (a promise he had already made in previous campaigns), he now tried to introduce a new tax instead of lowering one. Like Bucaram, Sánchez de Lozada also failed (see Chapter 5.2). Still, the evidence for the detrimental effects of policy-switching on policy-making is inconclusive. Firstly, in the examples referred to, there are a number of factors that caused the failure of the tax reform. In Sánchez de Lozada's case, for example, while the policy switch may have contributed to the failure, other aspects (e.g. failure in communication, lack of legitimacy, fragile coalition) all need to be taken into account to explain this unsuccessful attempt. Secondly, there are several cases where presidents changed their policy agenda and still were successful in introducing reforms. Paz Zamora, representing the clearest case of a mandate switch as regards Bolivia, for example, managed to carry out two major tax increases in 1990 and 1992. Ecuador's Febres Cordero also significantly departed from his electoral platform and still managed to raise VAT by four points in 1986. In short, though mandate switches may have made introducing reforms more difficult in some cases, the evidence is inconclusive and other aspects provide a more coherent explanation of the pattern of tax policy-making in Ecuador and Bolivia.

It appears that neither interest groups, external influence or presidents' policy positions but the institutional analysis applied is the best explanation for the different tax policy-making processes that occurred in Ecuador and Bolivia during the 1980s and 1990s. Political structures led to coalition governments in Bolivia which were able to introduce wide-ranging economic reforms, while the lack of institutional incentives for coalition-building led to frequent failure of reforms in Ecuador. Though an institutional explanation accounts for a large number of cases, it does not hold invariably. The complex realities of Latin American politics cannot be adequately accounted for by single-variable explanations, as indicated in the introduction. Other aspects have also contributed to Ecuador's and Bolivia's pattern of policy-making.

8.3 Hyperinflation and Tax Reform

A second finding of this research holds that hyperinflation was an important political variable that facilitated a radical restructuring of Bolivia's tax system. In the literature on economic reform the economic crisis hypothesis has been taken up by various scholars. To name a few, Drazen and Grilli (1993) formulated the paradox that economic crisis can be welfare enhancing as they argued that introducing radical economic reforms is only possible if preceded by an economic crisis so that the measures would be acceptable given the losses citizens experience. Anne O. Krueger (1993:109) argued that policy reform would take place when *"economic conditions deteriorated sufficiently so that there emerged a political imperative for better economic performance"*. Applying prospect theory Kurt Weyland (2002a) showed how economic crises influenced the choices of political leaders and made them introduce risky policies. As regards the analysis of tax reforms in particular, the crisis explanation was used by Bird and Perry (1994:177) who argued that *"for the most part major changes in tax structure and administration are possible only when times are bad, that is, in a crisis of some sort"*.

Critics of the economic crisis hypothesis have questioned the usefulness of the approach.[137] They have pointed out that the concept of "crisis" is analytically difficult: what constitutes an economic crisis? When do countries reach the bottom with the

[137] For critical points of view, see for example: Corrales, 1997-8; 2002; Williamson and Haggard, 1994:565.

subsequent effect of triggering drastic reforms? Dani Rodrik, pointing out that crisis is necessarily the outcome of policy failure, considered that the sequence of crisis followed by reform *"is no more surprising than smoke following fire"* (1996:27). Other authors, however, have narrowed this approach down and have referred to inflation or hyperinflation as being a crucial trigger for economic reforms. Mancur Olson argued in 1982 that a major crisis, such as a war or hyperinflation, would provide a window of opportunity for introducing drastic economic policies (Olson, 1982) and the aforementioned Weyland argued that it is economic crises in the form of hyperinflation in particular that trigger bold reforms as a large number of people finds itself in the domain of losses in such a situation (Weyland, 2002a). Albert Hirschman argued in a similar way and considered that inflation had led to facilitating tax reforms in developing countries:

"When expenditures consistently outrun revenue the resulting inflation may have the effect of convincing the public and government that taxes must be raised to finance public investment. In the advanced industrial countries income taxation and big spurts in taxation generally, have become possible only under the impact of major emergency and crisis, mostly in wartime. In a number of developing countries inflation has acted as an equivalent of war in setting the stage for more forceful taxation." (Hirschman, 1985:76)[138]

The Bolivian case seems to confirm this argument. As we have seen in the previous chapters, Bolivia managed to introduce some sort of "tax revolution" in 1986 when it completely overhauled its tax system. Within the Latin American context it introduced one of the most wide-ranging reforms. The experience of hyperinflation had made the introduction of drastic reforms acceptable to Bolivians. Given that this period had such an existential character for the majority of the people, hyperinflation remained as a potential threat in their minds. Thus even after the situation stabilised people were willing to accept economic reforms that would prevent the country of falling back into hyperinflation. Even years later politicians used this threat to defend the introduction of tax reforms; and, as Cariaga argued, the tax reform of 1992, for example, was possible partly due to the memory of hyperinflation (Cariaga, interview, 21.5.2004). The tax reforms and other economic policies introduced in Bolivia from 1985 onwards cannot be understood without taking into account the experience of hyperinflation as it represented a turning point both in economic and in political terms for Bolivia. As maintained by Doria Medina (Interview, 25.5.2004) hyperinflation represented a

[138] For other authors referring particularly to the link between inflation and tax reforms see, for example, Mahon, 2004.

window of opportunity for introducing changes and in this sense the argument of George Philip (1998:86) that *"inflation is a key political variable"* can be applied to the Bolivian case.

While Ecuador never experienced inflation on a similar scale it certainly went through times of serious economic crisis. In 1999, Ecuador's economy all but collapsed: GDP declined by around 7.5 per cent, the real effective exchange rate depreciated by almost 50 per cent between 1998 and 1999; and inflation climbed from 30.7 per cent in 1997 to 52.0 per cent in 1999 (IMF, 2000b:7; INEC, 2005). This period is widely considered to be Ecuador's worst economic crisis in decades. Yet even in this situation introducing economic reforms was difficult. President Mahuad tried to introduce tax legislation three times and three times he failed to have his proposals approved. Only on his third attempt did the Congress make some concessions and agree to raise the VAT from 10 to 12 per cent (Mahuad's proposal was 15 per cent). This can hardly be classified as a drastic reform measure. In the case when he did introduce a radical change by dollarising Ecuador's economy – for which Mahuad did not need the approval of the Congress – political instability was the result as people protested against the measure and a few weeks later he was overthrown. This example shows the limits of the economic crisis hypothesis as economic crises do not necessarily pave the way for bold reforms. Bolivia in more recent times provides another example: since 2000 the fiscal deficit in Bolivia rose sharply from 3.8 per cent in 2000, to 6.5 in 2001, 8.7 in 2002 and 7.9 per cent in 2003 (EIU, Bolivia, 2004:39). Using fiscal deficits as an indicator Bolivia had certainly reached crisis level and the situation had become unsustainable. Yet this did not facilitate the introduction of economic reforms as the failure of President Sánchez de Lozada to introduce an income tax showed.

To summarise, the examples above show that hyperinflation was an important variable in facilitating the radical changes introduced to the tax system in Bolivia in 1986 and its aftermath. The mere existence of economic crises, however, did not trigger wide-ranging economic reforms in either Bolivia or Ecuador. Other variables, such as the political capacity of governments to introduce policies, were decisive. While this was not the major focus of this work and more research would need to be done, the evidence of these countries seems to question the economic crisis approach in its broad form but confirms its narrowed down version of using hyperinflation as a crucial variable in bringing about major economic policy changes.

8.4 How Coalition Politics Collapsed in Bolivia

With the resignation of Sánchez de Lozada, forced by a popular uprising in October 2003, the period of political stability Bolivia experienced since 1985 came to an end. While Sánchez de Lozada had set up a ruling coalition, apart from failing to introduce the tax reform, this coalition was unable (and also unwilling) to shield him from his eventual downfall. His successor, Carlos Mesa, did not make any attempt to form a coalition and decided to govern without the support of the political parties. The decline in the pattern of coalition politics did not occur overnight but was a gradual process: as mentioned in Chapter 5.1 already the "mega-coalition" of Banzer (1997-2002) was experiencing difficulties and since 2000 popular protest gained more and more momentum. The government had to change its course on a couple of policy measures (e.g. when trying to privatise Cochabamba's water supply in 2000). From this government onwards it also became increasingly difficult to introduce tax measures and the pattern of successfully introducing reforms in this area terminated.

Table 8.4: Tax Reforms in Bolivia since 2000

	President	Proposal of Government	Outcome
2000	Banzer	Increase in Excise Tax	Congress approves, later withdrawn (pressure of private sector)
2003	Sánchez de Lozada	Personal Income Tax of 12.5%	Popular protest forces President to withdraw proposal
2004	Mesa	a) 0.3% Financial Transactions Tax (FTT) b) 1.5% Net Property Tax c) Property and Vehicle Tax	Only a) approved

Source: Own elaboration.

While in 2000 Banzer still managed to make use of the ruling coalition in that it approved the excise tax increase in Congress, his weakened government was vulnerable to pressure from the private sector and he withdrew the measure a few months after having introduced it. In February 2003 the attempt of Sánchez de Lozada to introduce a Personal Income Tax failed due to massive popular protest against the bill. Finally, in 2004 Mesa managed to have only a small part of his tax policy proposal approved given that he lacked partisan support in Congress. These cases thus display a rather different pattern from the tax reforms introduced in the late 1980s and in the 1990s and give way for a comparative analysis of the processes within Bolivia.

Patronage logic. As previously mentioned, with the beginning of coalition politics in 1985 Bolivia managed to overcome the difficulties of governability in a fragmented Congress. The political pacts allowed presidents to introduce wide-ranging economic policies in a coherent way and Bolivia experienced a period of political stability. At the same time, however, these political pacts were based on the logic of patronage and required side payments to the political partners. As noted by Domingo (2001) the distribution of patronage is a normal procedure for any political system, yet Bolivia stands out for the degree of prevalence and for the number of challenges to democratic structures that patronage presents: *"Democratic legitimacy is undermined where patronage and clientelism dwarf other motors of political activity."* (Domingo, 2001:148). The salience of patronage politics has also been caused by the structure of the Bolivian economy, which has been largely unable to produce job opportunities for the urban middle class (Malloy, 1991:45). Napoleón Pacheco of the think tank *Fundación Milenio* analysed the effects of patronage-based coalition politics as follows:

"It is a political system that allows generating alliances in the second round which are then giving governability to the new government. I think it is a very useful system which produced interesting results, though with the time it deteriorated precisely because the formation of alliances in the Parliament resulted in the "cuoteo", in the distribution of quotas, of power to the members of the governing alliance. So I think based on this element, this mechanism of Bolivia's system was deteriorating and was loosing legitimacy to a great extent, the legitimacy it had in the population." (Pacheco, interview, 5.5.2004)

This patronage logic on which coalition politics was based also found expression in the way Bolivia failed to reduce or reform its public sector.

Public sector employment. Considering the patronage logic of coalition politics, Bolivia thus presents a good example for Philip's (2003) argument that the continuation of pre-democratic practices has undermined the process of democratic consolidation. While Bolivia was a radical reformer in almost all Washington Consensus reforms during the 1980s and 1990s, it was far less radical in reducing the size of the state. Though public sector employment was reduced during the last two decades, the number of employees almost exclusively fell in state industry; in other areas of the public sector employment increased from 1987 onwards. Between 1987 and 1997 central government employment rose from 129,300 to 180,470 and in recent years the trend has continued (see Chapter 3.1). While numbers increased gradually, a significant jump occurred from 160,782 people employed at central government level in 1996 to 180,470 in 1997. This increase can be explained by the fact that in 1997 Banzer came to power and formed a mega-coalition of rather heterogeneous parties to support his government and patronage logic became increasingly the driving force for keeping coalitions going.

Other data confirm the pattern of a continual failure of Bolivian governments to reduce spending on the public sector. Within Bolivia the weight of public sector salaries on the government budget has increased during the last years as it represented 38.8 per cent of current expenditure in 1998, rising to 48.5 per cent by 2003 (World Bank, 2004b:74). An upper rank public employee receives 22 times the amount of an average salary in the national economy, a ratio that within Latin America is higher only in Mexico (CLAD, 2004). Considering these indicators – the number of employees and the amount spent on public sector salaries – it becomes clear that the neoliberal reforms carried out in Bolivia from the government of Paz Estenssoro onwards, have not included a reduction of public sector expenditure. As a report of the World Bank *Bolivia: From Patronage to a Professional State* (2000a+b) described, Bolivia has failed to modernise its public sector which remains highly politicised. A survey published in this report shows that – according to public officials – government ministries are perceived to have a ratio of persons hired for political reasons of 38-68 per cent (depending on the ministry), while prefectures are perceived to have an average of 78 per cent of political hiring (World Bank, 2000a:58).[139] In a recent IADB study Bolivia – together with Paraguay, the Dominican Republic and the Central American countries (except Costa Rica) – is categorised as having a "clientelistic bureaucracy". Such a "clientelistic bureaucracy" is defined as a bureaucracy:

"characterized by low autonomy and low capacity. It is made up of public officials who temporarily enter government because of loyalty or party affiliation. ... The roles performed by clientistic bureaucracies are related to their nature primarily as a political resource of the governing party to exchange jobs for votes or political support. This type of bureaucracy is an extension of the political party. " (Stein et al., 2005:72).

Bolivia's failure to reform the public sector had two significant effects: the quality of public services provided is generally poor and the country continues to have high rates of poverty, which the government has been unable to bring down (World Bank, 2000a:8).

Trade-off Public Sector and Tax Reform. A link between the successful introduction of tax policies and failed public sector reform can be established. While coalition

[139] On reforms undertaken to modernise the public sector see also Sánchez de Lozada (2001:195-215); World Bank (2000a+b).

politics facilitated the introduction of significant changes to the tax system, which resulted in a substantial increase in tax collection, it prevented any success as regards the other side of fiscal policy as Bolivia failed to reduce its spending on the public sector. While this contradicts the logic of market-oriented reforms this development can be explained by political aspects: the coalitions that were formed to enhance governability were dependent on the distribution of patronage. To keep the coalitions together, therefore, presidents had to hand out public sector positions which in turn prevented the country from reducing spending and reforming its public sector. Facing this trade-off between public sector and tax reform, presidents in Bolivia repeatedly opted for increasing tax revenues to achieve fiscal balance. Paradoxically, therefore, the patronage-based coalitions that facilitated the introduction of tax reforms and other market-oriented reforms prevented the reduction and reform of the public sector. That there is a link between the use of patronage and a lack of public sector reform can be confirmed by comparing Bolivia to other countries of the region. In Venezuela, for example, the "Punto Fijo" system was highly dependent on patronage, which not only led to a decline in the quality of public sector services but also triggered huge discontent with the political class among the population.

While patronage-driven coalition politics generated stability and governability in Bolivia for some time, it proved disastrous in the long run. On the one hand Bolivia became more and more successful in collecting taxes and the burden on taxpayers increased. On the other hand, however, the increased payments were not matched by improvement in the services provided by the public sector. The frustration of the Bolivian population at this imbalance increased with the perception of wide-spread corruption among the political class. The media in Bolivia frequently reports on corruption scandals and the public takes a huge interest in them.

As the use of patronage within coalitions increased, so publicity of the issue rose and the traditional parties became more and more discredited. The three main parties ADN, MNR and MIR that dominated the political scene and had been at the forefront of all existing coalitions between 1985 and 2003 received fewer and fewer votes during this period (see Chapter 2.5). The parties represented in Congress gradually lost their legitimacy and the connections between parties and society all but disappeared. As parties were no longer considered capable of expressing societal interests, street politics became again an important factor in Bolivia, as had been the case in the years prior to 1985. Popular protest started to have an influence on political decisions mainly from the year 2000 and peaked in the overthrow of President Sánchez de Lozada in October 2003.

Combining the above conclusion concerning the way that Bolivia's political structures facilitated coalition-building and allowed presidents to introduce tax reform and other wide-ranging economic reforms, with the finding that the same pattern of coalition politics was based on patronage and prevented the downsizing of the public sector – one is confronted with a dualistic process that was summarised by the aforementioned World Bank Report (2000a:vii):

"This practice, called cuoteo politico *(political quota), has been the basis for formation and sustenance of governing coalitions, and thus of democratic stability. Relatively stable coalition arrangements have also facilitated legislative passage of certain key reform measures, including the macroeconomic stabilization in the mid 1980s. In that sense, patronage politics exercised through the practice of* cuoteo politico *has contributed to improved governance at the macro level. The problem is that this macro level governance has been achieved at the cost of deteriorating public services at the micro level because of the excessive politicization of the government bureaucracy..."*

Table 8.5: The Dual Effect of Coalitions

	Coalitions			
	⇙	⇘		
1985 - ~2003	Facilitated governance / Allowed introduction of tax and other economic reforms / Political stability	Required side payments ⇩ Political parties discredited ⇩	⇨	Prevented Public Sector Reform
2000 ...		Popular protest ⇩ Introducing economic policies more difficult / Political instability		

Source: Own elaboration.

The result of this process represented a paradox: the wide-ranging economic reforms introduced in Bolivia from 1985 were only possible due to the existence of coalitions which in turn were dependent on patronage. Patronage and its resulting effects on the public sector, however, contradicted the logic of the other neoliberal economic reforms introduced. While this pattern provided Bolivia with political stability for almost two decades, in the long run the pattern of coalition politics was undermining itself and was set to gradually decline and possibly lead to an eventual downfall.

The coalitions had another effect, the consequences of which became visible mainly in the long run. The process can be summarised as such: the political pacts required patronage payments to hold them together and over the years did so increasingly. This led to the political parties being more and more discredited and a gap between the formal political level and society evolved. Disillusioned with their leaders people took to the streets and the extra-institutional level became an important factor in Bolivian politics. Introducing economic policies became more difficult for presidents (for example, failed tax reform of February 2003) and the country lapsed back into political instability. It thus seems that the same institutions which facilitated the formation of coalitions and therefore governance for a certain period, led to extra-institutional political patterns in the long run.

This summary of the process is surely simplified and certainly many other aspects influenced the changes Bolivia experienced in the last few years. To name just one, the frustration of Bolivians with the lack of improvement in their living conditions after almost twenty years of austerity measures hugely influenced society's willingness to mobilise against their leaders. Yet without doubt, the patronage logic has undermined the pattern of coalition politics and has contributed to the situation of political instability Bolivia currently experiences. Political analyst Carlos Toranzo argued in a similar way as he considered this dual nature of coalition politics as one of the explanations for the situation of October 2003:

"Thus political stability is generated, I think it is an element of modernity of Bolivian politics but while we were creating modernity in parallel pre-modernity was created as the logic of the pact gave way to a clientelistic use of the state, to an excess of state patrimonialism and a prebendalistic use of the state. So we had a mixed result: political stability, political modernity, possibility for an understanding between the parties yet high levels of clientelism, patrimonialism and a prebendal use of the state which is one of the explanations for the crisis that happened in October last year." (Toranzo, interview, 5.5.2004)

This thesis has analysed the political dynamics of tax policy-making in Ecuador and Bolivia during the last two decades. Tax policies have been the main case study, but as shown in Chapter 3 these have been representative for other economic reform areas. The patterns established here therefore also indicate something about the dynamics of economic policy-making more generally. The analysis has made clear that to explain the politics of economic reforms it is important to look at institutional details and consider their influence on policies. The cases studied have shown that particular institutional elements – such as the congressional election of presidents or provisions regarding the legislative process – have frequently determined the success or failure of economic reforms. It was shown that it is of particular importance to include a political system's ability to produce coalitions as a variable, as this crucially impacted on presidential policy-making capacities. It has been demonstrated that external actors played only a limited role in the economic reform processes of Ecuador and Bolivia. This is an important aspect because both countries are comparatively small and due to their situation often dependent on financial support. This aspect makes a case for analysing predominantly domestic politics when studying economic reform processes. Though business groups have managed to gain some concessions in a few cases, they have equally not proven decisive in the majority of tax reforms undertaken. Given these findings it can be concluded that the influence of business groups or external actors is often overstated in research on Latin America. While the importance of institutional variables has thereby been established, other aspects – such as hyperinflation – have complemented the explanation under which conditions presidents are able to introduce economic reforms.

8.5 FURTHER RESEARCH

Since the aim of this work was to investigate the influence of institutional aspects on policy-making the issue of conditions for coalition formation raised in Chapter 2.7 could not be fully explored here. However, coalition-building in presidential regimes would make an exciting research topic involving, for example, a case study comparing two presidential systems that have produced coalitions. Furthermore, this thesis has considered the relationship between coalition politics, public sector reform and tax reform. This relationship still requires further analysis, however. To what extent has there been a trade-off between successful introduction of market-oriented policies and failure to reform the public sector due to persistent patronage logic in the political system? The fact that the two processes of political reform and economic liberalisation have largely happened simultaneously has led to the common assumption that the two are linked and reinforcing. Yet probably these two processes are often rather in conflict than in convergence with each other. Case studies analysing how pre-democratic forms of politics (e.g. patronage and corruption) have facilitated the introduction of market-oriented reforms, could further develop this assumption.

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El Comercio
Hoy
El Telégrafo

Appendices

Appendix A

Primary Sources and Methodology

The primary material used and gathered for this thesis comes from various sources. Interviews conducted in Ecuador and Bolivia represented an important source. How they were prepared, conducted and used is outlined in the following.

How the Interviews were Chosen. Before starting the actual interviews, extensive background research on the different tax reforms carried out in Ecuador and Bolivia was undertaken. By reading about the reforms mainly in newspaper articles and secondary literature, several names connected to these reforms were repeatedly mentioned which I then included in my list of potential interviewees. Given that the research analyses the processes and political dynamics of how tax reforms were introduced, the interviewees of most interest to me were those closely involved in the reform efforts. Since the research question focuses on the extent to which presidents are able to introduce the reforms they propose it naturally followed that the interviewees would be mainly those with close proximity to decision-making structures. The sampling frame was therefore largely elite focused. A preliminary list of people to be interviewed was devised before the field trip and mainly included those who participated directly in the decision-making process of a tax reform or had got involved in its discussion. In the course of events the list was constantly revised and the so-called "snowball strategy" was employed: at the end of each interview the respondents were asked which other persons they would advise me to talk to. This proved a very helpful procedure as these suggestions helped me to find out about the crucial people involved in the process and in several cases interviewees even helped to arrange my next interviews. Even when this was not the case it happened a few times that when phoning other people they had already heard from a previous interviewee about my research. While finding the snowball system a useful strategy the previously devised list helped to make sure that not only representatives of a certain social network were interviewed. However, though most people certainly recommended colleagues and friends, a number of people also recommended interviewees who would give a different perspective and opinion from theirs. The selection of interview partners depended largely also on their availability.

For example, several former presidents or finance ministers whom I would have liked to interview live in exile and were thus unavailable.

To be able to see the introduction of these policies from different perspectives the sampling frame consisted of people from a variety of sectors, including:

- Presidents, finance ministers and other cabinet members
- Members of Parliament and Chairpersons of the Legislative Commissions responsible for tax matters
- Central Bank presidents
- Directors and other staff of internal revenue services
- Representatives of private sector groups

(- Representatives of trade unions and social movements)

- Tax lawyers, representatives of think tanks, academics[141]

Presidents, finance ministers and other cabinet members were interviewed to find out how they went about developing the reform and convincing others to back it. To learn about the legislative level, interviews with Members of Parliament and chairpersons of the legislative commissions responsible for tax matters were conducted. Central Bank presidents as well as Directors and other staff of Bolivia's and Ecuador's internal revenue services provided information on technical aspects of the tax policies. To analyse the extent of opposition and influence of private sector groups, several representatives of this sector were interviewed. To get a similar perspective from trade unions and social movements several attempts were made to meet with leaders of this sector. Unfortunately, however, the attempts were largely unsuccessful as my meetings with a number of representatives kept on being postponed (until I had left) or the interviewees simply did not turn up (some of them failed to appear a number of times). To round up the perspective gathered interviews with a number of tax lawyers, representatives of prominent think tanks and academics were carried out. In addition some members of the National Electoral Courts were interviewed to gather knowledge about electoral procedures in Bolivia and Ecuador.

[141] For a full list of interviewees see Appendix B.

In sum, the sampling frame included a wide variety of actors so that different perspectives of the tax reforms could be gathered. Particular attention was paid to policy actors who were part of decision-making structures, their role in tax reform and their interpretation of events.[142]

<u>How the Interviews were Conducted.</u> Before starting the interviews a list of questions was prepared which had two sections: a first section contained general questions (e.g. which important tax reforms happened, what was their content, how was the process, who were the main actors involved etc.) which were put to all respondents. A second set of questions was designed to the specific knowledge of an interviewee (e.g. when interviewing someone who was involved in Ecuador's tax reform of 1989 specific questions concerning that case of reform were asked). This list of questions, or conversation guide, evolved over time as new insights were won in the early interviews. As pointed out by Rubin and Rubin (1995:43) *"Qualitative interviewing design is flexible, iterative and continuous, rather than prepared in advance and locked in stone."* These principles were followed and the prepared questions were used to conduct "semi-structured interviews": the wording and order of the questions was altered as appropriate in every situation. The aim was to make the interviews appear more like a conversation rather than a strict agenda of questions and answers. The interview structure was also flexible as probing was used to make the interviewees go more into detail when they had given a rather general answer only or when their answers went into an unsolicited direction which proved interesting.

At the beginning of each interview the interviewee was given some information about the researcher's background and the research undertaken. This often helped to show the interviewee that the researcher had some knowledge about the issue so that their answers were more detailed than they might otherwise have been. However, several respondents started off by giving rather general answers. They usually changed direction and went more into depth after I had included some technical terms or keywords into the next question asked.

The length of the interview was usually one to one-and-a-half hours and generally took place in the interviewees' office (in a few cases in a café or the interviewees' home).

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[142] For approaches to interviewing see: Arksey and Knight (1999); Bauer and Gaskell (eds.) (2000); Brenner et.al. (1985). For literature dealing particularly with elite interviewing see: Ball (1994); Berry (2002); Davies (2001); Dexter (1970); Goldstein (2002); Lilleker (2003); Richards (1996); Rubin & Rubin (1995).

Interviews were carried out in Quito, Guayaquil, La Paz and London. The interviews arranged in Cochabamba had to be cancelled due to road blockages occurring in Bolivia during my stay. All interviews but one were tape recorded to which all respondents had agreed. In two cases I was asked to switch off the tape recorder for a certain time during the interview when sensitive information was given.

The process of interviewing was a learning process. My interview techniques of probing, including key words, making interviewees go back to the actual topic without showing that what they had previously said was not that relevant or generally to shape the interview into an easily flowing conversation, yet at the same time managing to ask all questions on my list developed over time and from interview to interview. I also experienced the interviews as a highly enjoyable activity – it gave colour to the issues researched and gave motivation for the work ahead.

How the Data was Used. In total 67 interviews were carried out. Since in qualitative interviewing there is no clear definition as to how many people should be interviewed the number came together for two reasons. At a practical level I simply tried to do as many interviews as possible while in Ecuador and Bolivia as it was clear that another field trip – at least not to both countries – would be very difficult if not impossible. At the level of gathering data there was a stage in the interview process when stories and interpretations repeated themselves and it seemed that I had heard a sufficient variety of voices on the theme. Glaser and Strauss (1967) have called this process *"theoretical saturation"*.

All tape recorded interviews were subsequently transcribed so that the analysis could rely on the full text. Subsequently the texts were read and re-read in different stages in a coding process. Certain passages and quotes were marked and grouped into categories so that what different people said on a certain theme could be compared. The interviews were coded according to the year of the tax reform and in the sub-categories of the background of this tax reform, its contents, the process, opposition to the reform, the actors involved, and why the interviewee thought the reform was possible or obstructed. The collected interview passages were then grouped into the different categories and sub-categories. When analysing this data an interviewee's statement or point of view was included in the analysis if it was backed up by another respondent or other material used.

Other Sources. The information gathered via the interviews was then contrasted with evidence found in other sources.

Newspapers. To complement this material, newspapers proved to be an important source and around 1400 articles were consulted. They provided results of voting on tax reforms in the Congress, behind-the-scenes information, speeches, and evidence of dynamics of the coalitions. They also gave evidence of the reaction of private sector groups to the reforms and their attempts to influence them (e.g. by carrying out media campaigns) as well as popular protest against the tax policies. Evidence from the newspapers was of particular importance for the tax reforms that lie further back as the interview partners remembered more details of those reforms that were introduced more recently.

The Bolivian newspaper *El Diario* and the Ecuadorian *El Comercio* of the last two decades were consulted systematically at Colindale, the newspaper branch of the British Library. For articles of the last two to three years (useful mainly for the case studies of 2003 and 2004 in Bolivia) a wider range of newspapers was consulted via the internet.

Documents. The minutes of the legislature's discussion on some of the tax reforms were researched in the Ecuadorian and Bolivian Libraries of Congress. This was done to get a better understanding of the procedures and discussions within the legislature. Both libraries proved useful for researching the members of the legislative committees responsible for tax reform during the last twenty years. Former and current Members of Parliament were contacted after this research had been made as it was assumed that MPs who participated in these commissions would remember the discussions of the tax reforms most. The access to the documents in these libraries was limited, however. In Ecuador the Congress building had burned down a few months before my field trip. Though the Congress library was unharmed it was now based in a different building. This temporary arrangement meant that a lot of documents were not kept in the right order and some documents that would have been important for my research could not be found. While in Bolivia limitations of time prevented me from doing more extensive research in the library of Congress.

Several internal documents were provided by the Ministries of Finance and the Internal Revenue Services, which mainly provided technical information on the changes to the tax system.

Statistical data. For statistical data on economic aspects, the databases of the two Central Banks, the Internal Revenue Services as well as the International Monetary Fund (IMF) and World Bank were consulted. Some statistical data was rather hard to come by or was sometimes found to be contradicting. In those cases where no reliable data was found, it was left out. This explains why in Chapter 3 some economic data is only given for a certain time period rather than for the whole two decades considered.

The *Tribunal Supremo Electoral* (TSE) in Ecuador provided access to their databases with the election results of the last twenty years. Similar information was obtained from the Bolivian *Corte Nacional Electoral* (CNE) for recent elections; other electoral data was used from www.observatorioelectoral.org.

Appendix B

List of Interviews

Note: When no dates are given, position is held currently.

Ecuador

1) **Alberto ACOSTA** – Economist at ILDIS (Instituto Latinoamericano de Investigaciones Sociales) – *23.3. 2004 – Quito*

2) **Dr. Alfredo ARÍZAGA** – Minister of Finance (August 1999 – March 2000) – *31.3.2004 – Quito*

3) **Dr. Gustavo ARTETA** – Economist at CORDES (Corporación de Estudios para el Desarrollo) – *7.4.2004 – Quito*

4) **Dr. Pablo BETTER** – Minister of Finance (January 1991- August 1992); President of the Central Bank (June 1999 – 10th of January 2000) – *30.3.2004 – Quito*

5) **Dr. Rodrigo BORJA CEVALLOS** – President of Ecuador (1988-92) – *24.3.2004 – Quito*

6) **Simón BUSTAMANTE VERA** – Deputy of Partido Social Cristiano (PSC) 1990-96 and since 1998; Legislative Comission for Tax, Fiscal and Banking Matters (President 1998-2000; Member 1990-91, 1992-1995); President of the Legislative Commision for Economic, Agrarian, Industrial and Commercial Matters (since 2003) – *20.4.2004 – Quito*

7) **Eduardo CABEZAS** – Minister of Finance (January 1988 – August 1988); Ecuador's Ambassador in London since 2003 – *10.3.2004 – London*

8) **Jaime CARRERA** – Economist at Observatorio de la Política Fiscal; Sub-secretary of Budget Matters (during government of Mahuad) – *29.3.2004 – Quito*

9) **Dr. Fabian CORRAL** – Tax lawyer at Corral-Sanchez Abogados, Law Firm – Director Cámara de Comercio de Quito (1994-96, 1999-2001) – *6.4.2004 – Quito*

10) **Modesto CORREA** – Minister of Finance (September 1994 – April 1995) – President of the Central Bank 1/2000 - 5/2000 – *15.4.2004 – Guayaquil*

11) **Alegría DONOSO** – Historian, Author – *17.3.2004 – Quito*

12) **Carolyn ESPINOSA** – Economist at Ministry of Finance, Subsecretary of Political Economy – *18.3.2004 – Quito*

13) **Fander FALCONI** – Economist at FLACSO (Facultad Latinoamericana de Ciencias Sociales) Ecuador – *17.3.2004 – Quito (handwritten notes only, interview was not recorded)*

14) **Dr. Gustavo GUERRA** – Research Coordinator at Servicio de Rentas Internas (SRI), Tax Lawyer – *23.3.2004 – Quito*

15) **Dr. Raúl HURTADO LARREÁ** – President of Legislative Commission on Tax, Fiscal and Banking Matters 2000-02; Member of Parliament for Democracia Popular (DP) – *13.4.2004 – Quito*

16) **Elsa de MENA** – Director of Servicio de Rentas Internas (SRI) (September 1998-September 2004, again since April 2005) – *20.4.2004 – Quito*

17) **Dr. Marcelo MERLO** – Cámara de Comercio de Quito 1974-2001; General Comptroller of the State 1984-88; Minister of Government under Noboa 2000 – 2003 - *19.4.2004 – Quito*

18) **Teresa MINUCHE DE MERA** – President of Legislative Commission on Tax and Budget Matters 1992-93; Deputy for Partido Conservador (PC) 1992-94; Superintendent of Companies 1979-87 – *25.3.2004 – Quito*

19) **Jaime MORILLO BATTLE** – Minister of Finance (1975-76 and November 1981 – September 1982) – Ex–President of Monetary Junta – *7.4.2004 – Quito*

20) **Dr. Xavier NEIRA MENENDEZ** – Party leader Partido Socialcristiano (PSC), Deputy PSC – *16.4.2004 – Guayaquil*

21) **Jorge ORTIZ** – Journalist - *30.3.2004 – Quito*

22) **Simón PACHANO** – Political Scientist FLACSO (Facultad Latinoamericana de Ciencias Sociales) Ecuador – *18.3.2004 – Quito*

23) **Dr. Pablo Lucio PAREDES** – Professor and Director of Research at Escuela de Dirección de Empresas (IDE); Economist – *7.4.2004 – Quito*

24) **Alonso PÈREZ-KAKABADSE** – Vice-minister of the Economy (October 1999 – August 2000 + July 2002 – September 2002); Economic Advisor to President Noboa (September 2000 – June 2002) – *3.12.2004 – London.*

25) **Mario RIBADENEIRA** – Minister of Finance (August 1992 – July 1993); President of Cámara de Comercio de Quito (March 2002 – March 2004) – (currently) Empresa Morisaenz (cars) and President of Consejo Empresario de América Latina – *20.4.2004 – Quito*

26) **César ROBALINO** – Minister of Finance (1976; May 1981 – November 1981; July 1993 – September 1994) – (currently) Vice-president Regional Banco de Guayaquil – *5.4.2004 – Quito*

27) **Wilson RUALES** – Tax Expert, Adviser to Director at Servicio de Rentas Internas (SRI) – *23.3.2004 – Quito*

28) **Carlos SANDOVAL** – President of Tax Commission elaborating tax reform of 1989; Consultant at GTZ (Gesellschaft für Technische Zusammenarbeit) – *26.3.2004 – Quito*

29) **Dr. Victor Hugo SICOURET** – Minister of Housing (August 1996 – February 1997); Deputy and leader of PRE – *16.4.2004 – Guayaquil*

30) **Francisco SWETT** – Minister of Finance (August 1984 – June 1986) – President of Central Bank 1998 – *15.4.2004 – Guayaquil*

31) **Eduardo VALENCIA** – Professor Universidad Católica del Ecuador, Instituto de Investigaciones Económicas – *2.4.2004 – Quito*

32) **Dr. Patricio VIVANCO** – Deputy of Democracia Popular (DP) 1988-1990; Member of Legislative Commission on Tax, Banking, Fiscal and Budget Matters; President of Tribunal Supremo Electoral 1997-98 – *1.4.2004 – Quito*

__Bolivia__

1) **Dr. Eduardo ANTELO Callisperis** – Vice-minister of the Treasury (March 2001 – August 2002); Vice-minister of the Budget (May 2000 – February 2001) – *24.5.2004 – La Paz*

2) **David BLANCO** – Minister of Finance (August 1989 – February 1992) – *30.4.2004 – La Paz*

3) **Ramiro CABEZAS** – Superintendente Tributario; Minister of Tax Collection 1986-87; Minister of Finance 1988-89 – *29.4.2004 – La Paz*

4) **Fernando CANDÍA** – Minister of Finance (August 1995 – August 1997); Vice-minister of Political Economy 1986-89 – *6.5. 2004 – La Paz*

5) **Juan CARIAGA** – one of the authors of Decree 21060; Minister of Planning (January 1986 – August 1988); Executive Director at World Bank 1996-99; Executive Director IDB 1988-91; Director Central Bank of Bolivia 1974-75 – *21.5.2004 – La Paz*

6) **Fernando COSSIO** – Vice-minister of Tax Politics 2002 – December 2003 – *10.5.2004 – La Paz*

7) **Samuel DORIA MEDINA** – Entrepreneur (Sociedad Boliviana del Cemento – SOBOCE); Minister of Planning and Co-ordination 1991-93; Party leader of Unidad Nacional (UN, founded in 2003), previously member of the MIR – *25.5.2004 – La Paz*

8) **Maria FELIX** – Tax Analyst Unidad de Análisis de Políticas Sociales y Económicas (UDAPE) – *30.4.2004 – La Paz*

9) **Dr. George GRAY-MOLINA** – Ex-Director UDAPE (until March 2004); UNDP Bolivia – *7.5.2004 – La Paz*

10) **Fernando ILLANES** – President of Confederación de Empresarios Privados de Bolivia (CEPB) 1982-85, 1992-93; Minister of Finance (August 1993 – March 1994) – *4.5.2004 – La Paz*

11) **Bernard INCH CALVIMONTE** – Economic Commission of the Legislature (1997-2001, 1998-2000 its President; currently its adviser); Member of Parliament for the NFR (1997-2002) – *13.5.2004 – La Paz*

12) **Alberto MACHICADO** – Vice-minister of Tax Politics (August 1997 – August 2002) – *25.5.2004 – La Paz*

13) **Dr. H. C. Felipe MANSILLA** – Political scientist and author – *1.5.2004 – La Paz*

14) **Armando MÉNDEZ** – President of the Central Bank 1992-93; Vice-president Central Bank 2000-03 - *7.5.2004 – La Paz*

15) **Edgar MILLARES** – Minister of Finance (August 1997 – August 1998) – *29.4.2004 – La Paz*

16) **Dr. Juan Antonio MORALES** – President of the Central Bank since 1996 – *24.5.2004 – La Paz*

17) **Herbert MÜLLER** – Minister of Finance (August 1998 – April 2000) – *10.5.2004 – La Paz*

18) **Francisco MUÑOZ** – (previously) Tax Analyst at PriceWaterhouseCoopers – *11.5.2004 – La Paz*

19) **Carlos OTÁLORA** – Regional Tax Superintendent for La Paz since 2004; General Director of Internal Revenue Service (General de la Dirección General de Impuestos Internos) 1983, 1996-7 – *12.5.2004 – La Paz*

20) **Napoleón PACHECO** – Director Fundación Milenio – *5.5.2004 – La Paz*

21) **Eduardo PAZ RADA** – Legislative Comission on Planning, Political Economy and Finances 1993-95; Deputy for CONDEPA 1990-2002 – *26.5.2004 – La Paz*

22) **Jaime PAZ ZAMORA** – President of Bolivia 1989-93 – *19.5.2004 – La Paz*

23) **Juan Carlos PEREIRA** – Director of Internal Revenue Service 1989-93; internacional tax consultant; (currently) one of the directors of Servicio de Impuestos Nacionales (SIN*) – 28.5.2004 – La Paz*

24) **Fernando ROMERO** – President Confederación de Empresarios Privados de Bolivia (CEPB) 1985; Member of team developing Decree 21060; Minister of Planning 1988-89; Minister of Human Development 1993-97 – *25.5.2004 – La Paz*

25) **Dr. Sandra ROMERO** – Chamber of Industry, Vice-manager of Legal and Tax Matters – *28.5.2004 – La Paz*

26) **Dr. Salvador ROMERO BALLIVIAN** – "Vocal" of Corte Nacional Electoral (CNE) – *28.4.2004 – La Paz*

27) **Dr. Santos RAMÍREZ Valverde** – Head of the economic team of the MAS; Deputy MAS – *31.5.2004 – La Paz*

28) **Waldo SERRUTO** – Manager for the Hydrocarbons Sector (interim), Servicio de Impuestos Internos – *31.5.2004 – La Paz*

29) **Rosa TALAVERA** – Tax Analyst, PriceWaterhouseCoopers – *20.5.2004 – La Paz*

30) **Carlos TORANZO** – Director of ILDIS (Instituto Latinoamericano de Investigaciones Sociales) – *5.5.2004 – La Paz*

31) **Jaques TRIGO LOUBIERE** – Minister of Finance (August 2001 – August 2002); Banking Superintendent 1995-2001; President of the Central Bank 1988-89 – *20.5.2004 – La Paz*

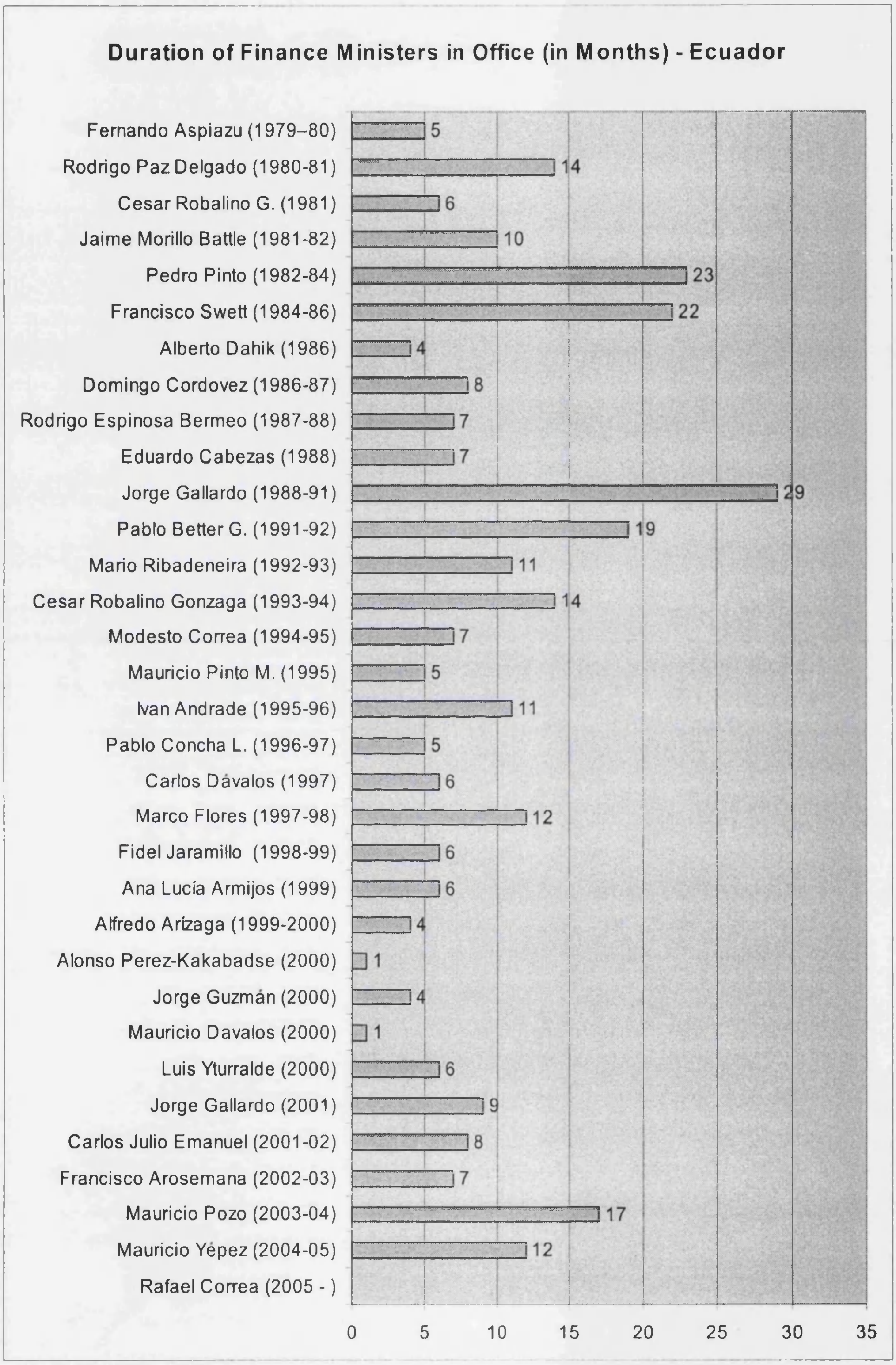
32) **Dr. Juan Cristóbal URIOSTE** – Superintendent (interim) Pensions, Securities, and Insurance; Constitutional expert – *11.5.2004 – La Paz*

33) **Gerardo VELASCO** – Manager Chamber of Industry (CNI) – *27.5.2004 – La Paz*

34) **Gonzalo M. VIDAURRE ANDRADE** – Chamber of Industry (CNI), Vice-manager for Economic Research – *28.5.2004 – La Paz*

35) **Álvaro VILLEGAS** – Tax Lawyer; consultant for February 2003 income tax proposal – *28.5.2004 – La Paz*

Appendix C



Average Duration of Finance Ministers in Office (1979 – April 2005): 9.6 months

Source: Own elaboration.

Appendix D

Table – Trend of Consumer Prices (% change on previous year), Bolivia

	Bolivia	**Ecuador**
1980	47.2	11.9
1981	32.1	14.0
1982	123.5	16.2
1983	275.6	47.8
1984	1281.4	32.8
1985	11749.6	28.1
1986	276.4	23.0
1987	14.6	29.4
1988	16.0	57.0
1989	15.2	78.1
1990	17.1	48.5
1991	21.4	48.8
1992	12.1	54.0
1993	8.5	46.4
1994	7.9	27.5
1995	10.2	23.0
1996	12.4	24.4
1997	4.7	30.7
1998	7.7	35.8
1999	2.2	52.0
2000	4.6	95.5
2001	1.6	40.3
2002	0.9	12.6
2003	3.3	8.0
2004	4.4	2.8

Source: Own elaboration. Data Bolivia: INE, 2005; INEC, 2005.

Appendix E

Elements of Bolivia's 1986 Tax Reform

Value-added Tax (VAT). At the heart of the new structure was a Value-added Tax (VAT): the previously existing over 400 sales taxes were combined into a unified 10 percent Value-added Tax. An unusually wide range of exemptions was abolished by this reform and VAT was now applied to all goods except exports, the sale of real estate and of shares, and interest on loans (the last three are exempt, however, as they are subject to other taxes). While in many other countries in Latin America basic goods are exempt from VAT, Bolivia eliminated also these exemptions thus establishing a very broad base. VAT soon turned into the principal tax of the tax system and by 1988 generated over half of the total internal tax revenues (excluding customs duties and hydrocarbons taxes) (Mann, 1990:33). Bolivia's VAT rate of 10% is tax inclusive. The VAT is incorporated in the price of the product, so the effective VAT rate is 11% of the price excluding the tax itself. When the rate was increased to 13% in 1992, the effective rate rose to 14.92%.

"Complementary Tax". One of the most striking features of the Bolivian tax reform was that both personal and corporate income taxes were abolished; few tax systems in the world do not have an income tax. In their place other taxes were introduced, thus the so-called "Complementary Tax" became the successor of the personal income tax. The *Régimen Complementario al Impuesto al Valor Agregado* (RC-IVA, Complementary Regime to the Value-added Tax) implied a 10 percent withholding tax on all income - such as salaries, wages, rentals, interest, royalties etc. – paid to individuals. Ramiro Cabezas, considered as the inventor of this tax, explained it as follows:

"We implemented the complementary regime to the value-added tax as a personal income tax; however the name already tells that it is not a personal income tax but a complementary tax to the VAT. The objective of this tax was that every citizen and taxpayer would turn into a kind of inspector and would demand an invoice because every invoice has a value as the invoice of all their purchases allows them to deduct the VAT they had paid for their purchases from their personal income tax." (Cabezas, interview, 29.4.2004)

As Cabezas made clear the "Complementary Tax" thus not only had the aim to gain revenues but was also introduced as an enforcement mechanism of the VAT: it provided people with an incentive to demand invoices – which shops otherwise might not have given voluntarily in order to avoid declaring that sale – as they could use them to offset them against the 10 percent tax on their incomes. In consequence, if they managed to present invoices for 10 percent or more of their income they would not have to pay this tax at all. The "Complementary Tax" was not levied on total income, but two minimum salaries could be deducted from the monthly income, thus aiming to benefit people of low income (later on this was increased to four minimum salaries). Another reason for abolishing the personal income tax was that after the process of hyperinflation it was very difficult to determine how much people earned, there was no record or anything, so that the government decided to go for a tax that was much easier to administer, as was pointed out by Juan Cariaga, one of the core members of the economic team that had developed this tax reform (Cariaga, interview, 21.5.2004).

2 percent Tax on Presumed Profits of Companies. Just as the Personal Income Tax was eliminated by the 1986 reform, so was the Corporate Income Tax and in its place a 2 percent tax on the Presumed Profits of Companies was introduced (in 1988 the rate was increased to 2.5%). Not only was this tax easier to administer it was also considered that tax evasion was much more difficult with the taxation of presumed profits rather than income. Samuel Doria Medina, one of Bolivia's principal entrepreneurs, accounted for the choice of this tax:

"In 1986 a tax on the presumptive income was introduced as the companies were working wonders with their balances, everyone lost, no one showed any gains. In consequence it was said it would be a tax on assets, on the net worth. Thus the concept was simple so that they would not cheat the tax on presumptive income, and it was efficient but very regressive." (Doria Medina, interview, 25.5.2004)

As was also the case with the other taxes introduced, the 2 percent tax on the presumed profits equally had the objective of reducing possibilities for tax evasion and to contribute to the overall simplification of the tax system. Non-profitmaking associations and institutions and housing cooperatives were exempted from this tax, as were enterprises of the mining, hydrocarbon and electricity sector which were exempt given that they were subject to other taxes. As pointed out by Fernando Candía, Vice-minister for Political Economy at that time (1986-89), this tax was always planned as a transitory measure until a higher degree of institutionality was reached and a corporate income tax could be introduced (Candía, interview, 6.5.2004).

Property and Vehicle Tax. This tax was levied on real estate and vehicles. All owners – be it a corporation or a natural person – were to be charged this progressive tax on the rural or urban real property and on their automobiles, boats and airplanes. Rates ranged from 0.15 to 2.65 percent for real property and 0.5 to 4 percent for vehicles with rates varying according to value. Exempt from the tax were certain types of property such as state lands, school areas, and small rural landholdings. The property tax had existed in the previous tax regime and had been charged by the municipalities. The new property tax provided for much higher rates; municipal governments were to maintain receiving the revenue collected equalling the rates valid during the previous tax regime. For example, the rate levied by municipalities on real estate used to be 0.35%. Municipalities will continue to receive this 0.35% from the rate that is now higher, while the difference goes to the central government.

Transactions Tax. A 1 percent transactions tax on sales and other transfers of property was introduced, covering sales of goods and services: rents, professional fees, sales of shares, real estate properties, motor vehicles, aircraft, also transfers of property at death or by gift (the death and gift taxes were only introduced in March 1987 when the Congress decided to add these to the original law of 1986). To be exempt from paying this tax were salaries in the private and public sectors, interest payments and transactions carried out by governmental agencies, exporters, publishing houses and book importers, private educational institutions and diplomatic personnel.

"The tax on transactions, which originally was 1 percent, had a cascade effect: every time one produced a shirt, sold it to the trader one paid 1 percent, the trader sold it to the distributor, paid 1 percent, and the distributor – all paid this 1 percent so that if one adds this up it becomes quite a heavy charge because it is cascading." (Muñoz, interview, 11.5.2004)

Bolivia's prominent economic analyst of *PriceWaterhouseCoopers*, Francisco Muñoz, thus pointed to the negative effects of this tax as it was analysed by many people in the private sector which saw itself most affected by it. Tax analyst Richard M. Bird described this transactions tax as introduced in Bolivia as an "archaic form of sales tax" that was introduced to gain a bit more revenue (Bird, 1992:12).

Special Consumption Tax (also excise tax). In addition to the VAT and the 1 percent Transactions Tax another indirect tax was added in the form of the excise tax, which was imposed on several luxury items. Alcoholic beverages, tobacco products, perfumes, cosmetics and jewellery were taxed at rates between 30 and 50 percent. In 1988 some modifications were made as goods such as soft drinks, electrical goods, pottery and china, and automobiles were included in the regime, and several rates of existing products were changed (Bird, 1992:12).

Changes to the Administration. The reform as such represented a great change to the Bolivian tax administration as a large number of taxes had been abolished and as the remaining few taxes were geared towards an easy administration of them. Taxes like the VAT featured few exemptions, which also made them much easier to administer properly. However, apart from the wide-ranging changes to the actual tax system, the reform of 1986 also brought with it a number of changes to the tax administration, which were believed necessary to be able to benefit from the new tax system at all. A crucial change was that the payment of taxes was now processed via the banking system. Thus, rather than having to go to the Internal Revenue Office (which often involved a long time of waiting as, for example, in La Paz there had been only one office), taxpayers could now pay at almost any bank. While this not only made the whole process of paying taxes more convenient for taxpayers and speeded up the process considerably, this change also limited the interactions between tax officials and taxpayers thus significantly limiting opportunities for corruption. In addition, a process of reorganising and modernising the Internal Revenue Service was started. New staff was employed, manuals were elaborated and all employees underwent training courses in the tax laws and the new procedures that were introduced (Cabezas, 1990:538). Other administrative changes included considerably shortened tax forms and a huge increase in their distribution; tightening of penalties for non-compliers, for example some businesses were closed after failing to issue VAT receipts; and at governmental level a Ministry of Tax Collections was in place between January 1987 and late 1988 which during that period was the home of the Internal Revenue Service (before and after that time it was part of the Ministry of Finance) and was in charge of working out the regulations that were necessary in the aftermath of the tax reform approved in May 1986. Analysing the changes introduced to the Bolivian tax administration, Richard M. Bird said:

"The idea that the tax administration now has some idea of what is going on, at least in a major part of the economy, and can penalise non-compliers is something totally new in Bolivia. This realisation appears to have had a healthy effect in stimulating compliance." (Bird, 1992:16)

"Co-participation". The tax reform entailed provisions that not all tax collections would remain with the central government but that a so-called system of "coparticipación" (co-participation) would be established. Under this system: the central government would receive 75 percent of all tax income, the departments 10 percent, the municipalities 10 percent, and the universities 5 percent.

Tax Amnesty. The new tax legislation also entailed a tax amnesty, allowing taxpayers to pay a one-off tax for having their tax obligations until December 31st, 1985 forgiven. This one-off tax was a 3 percent tax on the presumed profits of enterprises and a 50 percent surcharge on property (real estate and vehicles). The tax amnesty allowed taxpayers a new beginning and more generally can be considered as complementing the new start the 1986 tax reform aimed to achieve after several years of complete chaos of the tax system and almost non-existent tax collection.

Appendix F

Political Parties
Please note that the following list only contains presidential parties or those that have played a significant role in ruling coalitions.

Ecuador

Democracia Popular (DP)
Centre-Left
The DP, previously called Democracia Cristiana, was founded in 1964. It was originally set up as a left-wing force basing its ideology in between capitalism and Marxism and combining it with the Catholic Church's social doctrine. It subsequently went through a significant transformation and by the 1980s had adopted a liberal economic doctrine. It had undergone a switch from the centre-left to the centre or centre-right. The party's main electoral support comes from the *sierra*, especially from the rural middle class. Currently this Christian Democratic party is considered a reformist party with a clearly-defined ideology and a technocratic image. In the 1979 elections DP candidate Osvaldo Hurtado won the vice-presidency and became President in 1981 after Roldós died in an air crash. In 1998 Jamil Mahuad of the DP was elected President and stayed in power until 2000.

Frente Radical Alfarista (FRA)
Secular Centre-Right
The FRA was set up in 1972 by Abdón Calderón who had left the liberal party. Calderón was assassinated in the late 1970s and replaced by his daughter. During the 1990s the FRA's leader was Fabian Alarcón. With the exceptions of the 1984 and 1986 elections (where it won six and four seats respectively) it has never won more than three seats in Congress. Its leader Fabian Alarcón was appointed as interim President after Bucaram (PRE) had left in 1997 and stayed in this position until 1998.

Izquierda Democrática (ID)
Centre-Left
The ID was founded in the early 1970s (officially registered in 1978) by Rodrigo Borja and others who split up from the Liberals. Similarly to the DP it was set up as an alternative to the traditional political parties and considered itself particularly to be an opposition to the governments of Velasco Ibarra. Probably more than any other Ecuadorian party the ID has a firm ideological programme based on social democratic thinking. It belongs to the international federation of social democratic parties. In the preamble of its party programme it states: *"within the ideological framework of democratic socialism"*, the ID promotes *"a state that would be an agent of economic and social development of the Ecuadorian people, the re-distribution of income, the rational and full exploitation of the natural resources, and the breaking-off from external dependence"*. The ID advocates a mixed economic model in which the state directs the economy while at the same time foster the development of the private sector. While largely abiding by its social-democratic ideology, the ID changed some of its views after it had been in power from 1988 to 1992. While previously stressing the role of the state, their economic programme changed to acknowledge that the use of market mechanism in certain areas would be more efficient. The ID has its electoral base in the *sierra* and is supported mainly by Quito's middle class, the peasantry, and trade unionists. In 1988 its candidate Rodrigo Borja was elected president and stayed in power until 1992.

Partido Roldosista Ecuatoriano (PRE)

Personalist

The PRE was founded in 1983 by Abdalá Bucaram in Guayaquil. It was set up in competition to the PCD (*Pueblo, Cambio y Democracia*) led by León Roldós, brother of the late president Jaime Roldós and Bucaram's brother-in-law, which was in itself a split-up from Jaime Roldós' CFP (*Concentración de Fuerzas Populares*). The PRE understood itself as being more truthful to the political tradition of Jaime Roldós than the PCD. The party has a highly personalist character, with Bucaram acting as *"a personalist leader who converted the group in an extension of himself... he created an organisation to have a platform for projecting his own leadership"* Freidenberg (2001:344). The PRE's party platform states that it will carry out a great social change which will divest the oligarchy of its power and would introduce socially and economically just conditions. When elected to power in 1996, however, the policies chosen were of an orthodox nature. It is therefore difficult to classify the PRE ideologically. In a survey carried out by Freidenberg (2001:350) members of the PRE located the party on the left side of the scale, while members of other parties considered it to be clearly on the right. The party receives most of its support in the coastal regions, mainly among marginalised groups, and also the business sector from the coast that had emerged outside the traditional oligarchic circles. Abdalá Bucaram was elected president in 1996 and stayed in power until 1997.

Partido Social Cristiano (PSC)

Right

This party was founded in the 1951 as a group split up from the Conservatives and is therefore one of the oldest parties still competing today. It is the main party on the Right and has its electoral base mainly in the coastal provinces. Though the PSC only won the presidency once (in 1984), since Ecuador's return to democracy it is the party that has, on average, won most votes. Economically, the PSC aims to modernise the business sector and follows market-oriented ideas backing policies to limit the intervention of the state. The PSC is often considered to be closely allied with the business sectors of Guayaquil. Leon Febres Cordero was President in 1984-88; in 1992 former member Sixto Durán Ballén was elected President only a few months after he had left the PSC and set up his own party, the *Partido Unidad Republicana* (PUR).

Sources: Corkill and Cubitt, 1988; Albán G. et al., 1994; Sanderson, 2000; Freidenberg, 2001; Coppedge, 1998a+b.

<u>Bolivia</u>

Acción Democrática Nacionalista (ADN)

Right

The ADN was founded in 1979 around the former dictator Hugo Banzer Suárez (1971-78). Its economic programme considers the free-market system as the most efficient way of distributing resources and the ADN has consequently supported market-oriented reforms during the last two decades. The party has close connections to the business sector and represents its interests as well as that of the middle class. It represented the second biggest party after the MNR as regards votes received in elections between 1985 and 2002 (though in the 2002 elections it all but disappeared). Banzer was elected president in 1997 but could not fulfil his term as he stepped down in 2001 and handed over to Vice-president Jorge Quiroga after he was diagnosed lung cancer.

Conciencia de Patria (CONDEPA)
Personalist
CONDEPA was set up in 1988 by Bolivia's media mogul Carlos Palenque. The party lobbied against neoliberal economic policies, and received most electoral support from the aymara speaking population of La Paz and El Alto. Its economic programme is largely defined by a critique of neoliberal policies. A few months before the 1997 elections Palenque died and Remedios Loza took over as leader of the party. Internal conflicts ensued and by the 2002 elections the party had been dissolved. CONDEPA participated as coalition partner in the government of Banzer in 1997 but had already left it by 1998. Condepa won 9% of the votes in 1989, 10% in 1993, and 13% in 1997.

Movimiento de la Izquierda Revolucionaria (MIR)
Centre-Left
The MIR was founded in 1971 by Jaime Paz Zamora, Oscar Eid and other young militants who had split up from the *Partido Democrático Cristiano*. During the period of Banzer's dictatorship several leaders of the MIR were persecuted and went into exile or were killed. While originally having its programmatic base in revolutionary Marxism, the MIR has gradually assumed more moderate and reformist positions in line with social democratic thought. Particularly by indirectly supporting Paz Estenssoro's *New Economic Policy* and by co-governing with Banzer's ADN in 1989-93, the MIR's position had moved to accepting a market-oriented approach and structural reforms. Interestingly, members of the MIR consider their party as centre-left, while members of other parties consider it as centre-right (survey was undertaken in 1996-99; García, 2001:98-99). During the 1990s leaders of the MIR were repeatedly accused of having links to narco-traffickers, which lastingly damaged the party's reputation and negatively impacted on its election results. The MIR represented the third-biggest party – as regards votes received – during the elections between 1985 and 2002. Paz Zamora held the presidency in 1989-93.

Movimiento Nacionalista Revolucionario (MNR)
Centre-Right
The MNR was founded in 1941 by Victor Paz Estenssoro, Hernán Siles Zuazo (who later split from the party) and others and is thus the oldest party still forming part of Bolivia's political arena. Since the mid-1980s its programme has been committed to economic liberalisation, political modernisation, and a rational and technocratic approach. In the elections between 1985 and 2002 it has, on average, received the largest number of votes. Since 1985 the MNR held the presidency three times: 1985-89 under Paz Estenssoro, 1993-97 and 2003-03 under Sánchez de Lozada.

Nueva Fuerza Republicana (NFR)
Personalist
In the 1997 elections NFR participated as part of an electoral alliance with the ADN but left the coalition in 2000. In 2002 the NFR first participated individually on the national level and received 27% of the votes. The leader of the party is Manfred Reyes Villa, the Mayor of Cochabamba. He was leading the polls for a long time but in the end came only third. The party positions itself as an alternative to the traditional parties and promises to put the state back in charge of the economy. The NFR also announced that the capitalisation process would be revised.

Unión Cívica Solidaridad (UCS)

Personalist

The UCS was founded in 1989 by Max Fernández, owner of Bolivia's largest beer brewery. It has its support base mainly among the urban poor but also among the business sector in Santa Cruz. Its identity is largely based on distancing itself from the traditional parties and its economic policy programme is generally rather void of specific proposals. Categorising the UCS is therefore difficult. As Morales stated: *"neither the ideology nor economic program of the UCS are known, and it is not clear if the populist label often ascribed to it is even appropriate"* (Morales, 1994:133). When party members were asked to locate their party within a left-right spectrum, most of them assigned it to a centre position (García, 2001:123). The party's past election campaigns were accompanied by activities such as building schools, hospitals, or distributing food and consumer goods in rural areas, which made a commentator describe Fernández as *"a combination of Donald Trump and Santa Claus"* (quoted in Gamarra, 1994:119). After Max Fernández died in a plane crash in 1995, the party leadership was passed on to his son Johnny Fernández. The party participated in the coalition governments of Sánchez de Lozada (1993-97 and 2002-03) and Banzer and Quiroga (1997-2002). While the party received strong support in its first elections and won 15% in 1993 and 16% in 1997, it gained only 5% in 2002.

Sources: Gamarra and Malloy, 1995; García, 2001; Fundación Milenio 2002+2003; Domingo, 2001; Coppedge, 1998a+b; Election data from CNE.

Appendix G

Bolivia: Overview of Tax System, 1986 – 2004

Note that the dates in the tables below indicate when the decision on the tax was taken, not when it started to be charged.

	1986	1990	1992	1994	2000 (January)	2000 (November)	2004
VAT *(Impuesto al Valor Agregado - IVA)*	10%		13%				
"Complementary Tax" *(Régimen Complementario al IVA – RC-IVA)*	10%		13%				
Tax on the Presumed Profits of Companies *(Impuesto a la Renta Presunta de las Empresas – IRPE)*	2%			Abolished			
Corporate Income Tax *(Impuesto sobre las Utilidades de las Empresas - IUE)*	---			25%			
Transactions Tax *(Impuesto a las Transacciones - IT)*	1%	2%		3%			
Special Consumption Tax (or Excise Tax) *(Impuesto as los Consumos Específicos - ICE)*	30% + 50%[143]			18% + 50%[144]	21%-33% + 56%[145]	18% + 50%[2]	
Property and Vehicle Tax	Property: 0.15% - 2.65% Vehicles: 0.5% - 4%[146]			Property: 0.35% - 1.5% Vehicles: 1.5% - 5%[147]			
Financial Transactions Tax *(Impuesto a las Transacciones Financieras - ITF)*	---						0.3%

Source: Own elaboration. Data from Laws 843, 1141, 1314, 1606, 2047, 2152, 2646.

[143] 50% on cigarettes, tobacco and jewellery; 30% on beer, wine, spirits, perfume and cosmetics.
[144] 50% on cigarettes and tobacco; 18% on sale of cars; fixed rates for beer, wine and spirits (adjusted annually according to exchange rate).
[145] 56% on cigarettes and tobacco; 21-33% on sale of cars (depending on fuel and price); fixed charge on alcohol and soft drinks also increased.
[146] *Impuesto a la Renta Presunta de los Propietarios de Bienes – IRPPB.*
[147] *Impuesto a la Propiedad de Bienes Inmuebles y Vehículos Automotores* – IPBIVA.

Ecuador: Overview of Tax System, 1984 – 2001

<table>
<tr><th></th><th>1984</th><th>1989</th><th>1993</th><th>1995</th><th>1996</th><th>1997</th><th>1998</th><th>1999 (April)</th><th>1999 (November)</th><th>2000</th><th>2001</th></tr>
<tr><td>VAT (Impuesto al Valor Agregado)</td><td>10% (Sales Tax)</td><td colspan="7">10% (VAT)</td><td colspan="3">12%</td></tr>
<tr><td>Personal Income Tax (Impuesto a la Renta de Personas Naturales)</td><td rowspan="8"></td><td colspan="5">10% - 25%</td><td>Abolished</td><td>5% -15%</td><td colspan="3">5% - 25%</td></tr>
<tr><td>Corporate Income Tax (Impuesto a la Renta para Sociedades)</td><td colspan="3">25%</td><td colspan="2">20% (10%)</td><td>Abolished</td><td>15%</td><td colspan="3">25%</td></tr>
<tr><td>Special Consumption Tax (or Excise Tax) (Impuesto a los Consumos Especiales)</td><td>5% - 260%[i]</td><td>5% - 100%[ii]</td><td>5% - 67%[iii]</td><td>8% - 103%[iv]</td><td colspan="6">8% - 75%[v]</td></tr>
<tr><td>Tax on (Sale of) Vehicles (Impuesto a la Propiedad de los Vehículos)</td><td colspan="2">---</td><td>2%[vi]</td><td colspan="3">---</td><td>4%[vii]</td><td colspan="2">---</td><td>0.5% - 4%[viii]</td></tr>
<tr><td>Tax on Net Capital of Companies (Impuesto al Capital Neto de las Sociedades)</td><td colspan="3">---</td><td>1%</td><td colspan="6">---</td></tr>
<tr><td>Financial Transactions Tax (Impuesto a la Circulación de Capitales)</td><td colspan="5">---</td><td colspan="2">1%</td><td>0.8%</td><td colspan="2">Abolished</td></tr>
<tr><td>Tax on Corporate Assets (Impuesto al Patrimonio de las Sociedades)</td><td colspan="6">---</td><td>1% (one-off)</td><td colspan="3">---</td></tr>
<tr><td>Tax on Public Events (Impuesto a los Espectáculos Públicos)</td><td colspan="9">---</td><td>10%</td></tr>
</table>

Source: Own elaboration. Data from Laws 56, 51, 110, 06, s/n 31.7.97, 98-17, 99-24, 99-41, 2000-1, 2001-41.

[i] Cigarettes (Virginia tobacco) 200-260%; Cigarettes (black tobacco) 10-70%; Beer 85%; Soft Drinks 20%; Mineral and purified water 5%; Alcohol (other than beer) 100%.

[ii] Cigarettes (Virginia tobacco) 100%; Cigarettes (black tobacco) 25%; Beer 30%; Soft Drinks 12%; Mineral and purified water 5%; Alcohol (other than beer) 20%.

[iii] Cigarettes (Virginia tobacco) 67%; Cigarettes (black tobacco) 15%; Beer 30%; Soft Drinks 12%; Mineral and purified water 5%; Alcohol (other than beer) 20%.

[iv] Cigarettes (Virginia tobacco) 103%; Cigarettes (black tobacco) 48%; Beer 43%; Soft Drinks 15%; Mineral and purified water 8%; Alcohol (other than beer) 63%.

[v] Cigarettes (Virginia tobacco) 75%; Cigarettes (black tobacco) 18%; Beer 30%; Soft Drinks 10%; Mineral and purified water 8%; Alcohol (other than beer) 26%.

[vi] Impuesto Especial 2% Vehículos Defensa Nacional. One-off, on sale.

[vii] Impuesto a la Propiedad de los Vehículos de Lujo. One-off on luxury vehicles worth over ECS200m (~US$22,000); 5% on planes, helicopters, and yachts.

[viii] Impuesto a la Propiedad de los Vehículos.