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## **TAX REFORM IN GUATEMALA: ANALYSING THE MECHANISMS OF INTEREST GROUP INFLUENCE**

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### **ABSTRACT**

Guatemala has historically been burdened with one of the lowest levels of tax collection in Central America, while its tax structure is heavily biased towards organised business. This article analyses the role of interest group mechanisms in influencing Guatemalan tax policy. By extending the Stigler-Peltzman model of regulatory capture, the paper first provides a theoretical explanation for the persistent influence of interest groups on tax collection. Next, we will apply these theories to Guatemala's tax setting and analyse the attempted tax reforms of three Guatemalan administrations between 1996 and 2007 to demonstrate the methods employed by interest groups to prevent tax reforms from occurring. The paper argues that Guatemala's business groups operated through two primary mechanisms to stall reforms. Firstly, they hold close ties to political parties through campaign contributions and by providing staff-members. Secondly, they extend their influence through misinformation campaigns, which are aimed to draw in other societal players and convince them to protest against tax reforms that would have actually benefitted them. Guatemala is thus faced with the sad reality of an influential business sector that maintains its tax privileges both through financial contributions and the active campaigns of society's poorest.

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## I. INTRODUCTION

A government's tax structure demonstrates not only a state's finances; it also provides a powerful lens to assess the relative political strength of different domestic players. Guatemala's tax structure provides a worrying prospect on both accounts. Historically, Guatemala had one of the lowest tax burdens in Central America, and while it increased slightly between 1996 and 2002, it *decreased* after 2003, despite a decade of economic growth. This is particularly troubling as tax revenue is the state's main source of income: 94 percent in 2008 (CESR, 2009). Yet, Guatemala's taxes also reflect the country's skewed political relations. With a tax structure consisting primarily of indirect taxes on consumption (over 75 percent), the tax burden falls largely on low-income families. In contrast, high-income families pay a lower share of taxes in proportion to their income, as direct taxation on income and assets is low. Moreover, profitable business sectors all receive significant tax exemptions and privileges to the extent that in 2008, "for each quetzal collected in income tax, the state 'gave back' more than 2.5 quetzals in exemptions and deductions" (CESR, 2009, p.18).

Guatemala's low tax revenue thus reflects the weakness of state finances, while the tax structure demonstrates a strong bias towards organised business. This article analyses interest group mechanisms used by organised businesses to influence Guatemalan tax policy. Firstly, it addresses why Guatemala's transition towards democracy was expected to bring about increases in tax collection. Next, it provides a theoretical explanation for the limited tax collection based on an observation of the persistent influence of interest groups, extending the Stigler-Peltzman model of regulatory capture. Subsequently, the paper applies these theories to Guatemala's tax setting and describes the diverse set of mechanisms employed by interest groups to prevent tax reforms from occurring.

## II. GUATEMALA'S TRANSITION TO DEMOCRACY

Due to its heavy reliance on coffee exports, Guatemala has been burdened with a strong and influential landed elite dating back to colonial times. It wasn't until the early 1950s that this group was first challenged by popular revolts, demanding democracy and social reforms. Yet, rather than acceding power and initiating a democratic transition, a military coup banned all unions and political parties. Moreover, the military unified itself with the landowning elites by appropriating large estates. Because the wealthiest group in society, landowners, provided the political support for the military regime, they managed to strongly influence Guatemala's tax policy and prevent the state from mobilising a stable source of income. As a result, Guatemala's tax base remained very low because the military-landlord alliances had

no incentive to tax themselves or provide greater redistribution through public good provision (Di John and Putzel, 2009).

It comes as no surprise that leaders of a military autocracy choose not to institute tax reforms when they receive large profits and political support from maintaining a limited tax burden. However, as Guatemala moved towards a democracy by signing the 1996 Peace Accords, a large increase in tax collection was expected, as the opposition by economic elites would be less influential. In a democracy, any politician aiming to stay in power would have to adjust its proposed policies to maximise the number of votes it receives (Downs, 1957). As the new lower-income enfranchised masses prefer to vote for politicians proposing for wealth redistribution and increase the tax burden on higher-income citizens, we would expect economic policy to shift towards more progressive taxation. (Sanchez, 2009) Yet, as noted earlier, Guatemala's democratic elections did not bring large increases in tax collection and still reflects the interests of economic elites. How can this be the case?

### III. THEORETICAL FRAMEWORK

While democratic politicians ultimately seek to maximise their voter-support to remain in office, they will not always adopt the most popular policies following swing-voter views in the middle of opinion distributions known as the *median voter* (Downs, 1957). This is because citizens do not vote on every issue. Instead, politicians are elected to decide on a variety of subjects. Yet, as it is costly for individuals to inform themselves on every topic, only citizens with a large per-capita stake will learn about an issue and organise themselves to pressure politicians. This informational asymmetry allows politicians to deviate from the median voter and adopt positions of those who care most about the issue; interest groups (Olson, 1971).

Yet, not all individuals are equally likely to organise or finance campaigns. As the number of supporters for a particular policy increases, the per-capita benefits lowers while it becomes increasingly costly to organise. This limits individual commitment and induces 'free-riders' to benefit without campaign contributions, further lowering the per-capita benefits to campaigning.

'Collective action' will thus most likely take place by small groups with large per-capita benefits (Olson, 1971). Accordingly, Stigler notes producers have a strong advantage over consumers in influencing the legislative process. Because producers are fewer in numbers and face more homogenous interests, it is less costly for them to organise while having higher per capita gains in altering legislation. Hence, they can provide politicians with the necessary *financial support* and *human resources* such as staff-members.

He thus contends that “regulation is acquired by the industry and is designed and operated primarily for its benefits” (Stigler, 1971).

However, fiscal policy is not influenced by producer interest groups alone. To account for such behaviour, Peltzman extends Stigler’s model based on the assumption that politicians will only provide special benefits to interest groups if it maximise their net votes. Providing tax privileges to an industry will bring politicians electoral gains through financial and political support. Yet, the higher such privileges are, the greater the probability that consumers, bearing this tax burden, will vote against the regulator in the future. According to Peltzman, politicians will provide special benefits only up to the point where its electoral marginal gains equal marginal cost. Because consumer-perceptions are important, producers can also increase their reach altering those perceptions through ‘*voter education*’ campaigns (Peltzman, 1976).

This tension between voters and organised interest led Hacker and Pierson to argue that “the art for policy makers is not to respond to the median voter; it is to minimize trade-offs when the desires of powerful groups and the desires of voters collide” (Hacker and Pierson, 2010, p.173). This affirms the importance of *policy-making mechanisms*. High-profile political campaigns, for instance, are often the least effective method because they would highlight the acute tension between voter and interest groups. In contrast, technical regulation provides an ideal vehicle to privilege interest groups as its complexity will limit voter attention. They argue that the least costly manner to abandon voter preferences is through policy ‘*drift*’, the politically induced *inaction* of public policies to adapt to a dynamic economy. This is because *absence* of action is less likely to draw voter attention or be attributed to any policy-maker. Producers will thus retain their privileges through *low-visibility policies* and *agenda-setting* (Hacker and Pierson, 2010).

Our theoretical framework thus suggests that the business sector will be better organised, more unified and have more financial resources than other societal interests. Moreover, its key aim will be policy *drift*; to resist tax code changes and maintain its privileges. We predict two mechanisms are particularly important for Guatemala’s business groups to influence fiscal policy:

- It will attract political parties through *campaign contributions* and *staff-members*.
- It will limit voter opposition by *misinformation campaigns* and *agenda-setting*.

#### **IV. INTEREST GROUPS AND GUATEMALA'S TAX REFORM**

In Guatemalan policy-making, two sections of organised interests are most influential, the private sector lobby 'CACIF' and *civil society*.

Guatemala's business sector has been represented since 1954 by the '*Comité Coordinador de Asociaciones Agrícolas, Comerciales, Industriales y Financieras*' (CACIF). This umbrella association has a long history of defending elite interests, including by opposing labour union formation, rejecting demands to improve labour conditions and opposing increases in public spending. Rather than proposing national economic objectives, CACIF's operates primarily by *veto and obstruction*. When negotiating specific policies, these are largely static and short term, such as tax exemptions.

CACIF derives its political strength in part by *financing political parties*, who require capital to launch their campaigns and run party-secretaries (Sanchez, 2008). Moreover, *Guatemala's private media* are owned by a small group of business leaders, used widely for misinformation campaigns and agenda-setting. Furthermore, as CACIF's members are the primary sources of domestic capital investment, it can influence policy by *threatening to withdraw vital investments*. All these strengths ultimately derive from the ability of the business community to *effectively organise* and display a *unified position* on a range of policy-issues, most notably in taxation. (Sanchez, 2009)

Civil society organisations including labour unions, Catholic activist groups and student movements were nearly all destroyed by the highly repressive tactics of Guatemala's military regime in the 1970s and 1980s. Yet, the groups forming afterwards, including human rights and peasant organisations and new labour movements are all fragile and ill-financed. Their policy-influence is further reduced because each sector campaigns only around specific issues. This fragmentation provides a substantial collective action problem as it prevents them from adopting a common position. Furthermore, civil society's limited technical expertise linked with a common distrust of the state has allowed other players, most notably CACIF, to misinform organisations and have them campaign jointly against tax reforms that would benefit them (Sanchez, 2009).

#### **V. GUATEMALA'S TAX REFORMS – THREE ADMINISTRATIONS**

Since the 1996 Peace Agreement, several attempts have been made to institute tax reform, with mixed results. We now analyse the tax reform of three Guatemalan administrations between 1996 and 2007, to demonstrate the methods employed by interest groups to prevent tax reforms.

### 1. *The Arzú administration (1996-1999)*

Guatemala's first post-conflict President Álvaro Arzú Irigoyen of the '*Partido de Avanzada Nacional*' (PAN) was elected largely on his promise to make the Peace Accords targets central to his administration. As these set out ambitious targets to increase tax collection, Arzú proposed two significant tax reforms in 1997. The first set out to eliminate several deductions related to the VAT and income tax, expand corporate tax and introduce a tax on gasoline and alcoholic beverages. The second was the 'Single Property Tax', aiming to end the perverse practice whereby property-owners self-assessed the value of their property, which would bring in over three times the revenue. Both reforms would have made the tax structure substantially more progressive, as they shifted the tax burden on income, land and property (Sanchez, 2009).

Predictably, CACIF strongly opposed both tax packages. They argued the taxes unfairly concentrated the tax burden on 250,000 people paying income tax of a population of 11 million, despite the tax structure's strong bias against lower-income families. Next, CACIF newspaper advertisements declared the tax "a disincentive to investment that would have negative repercussions to the Guatemalan economy" (El Periódico, 1998). Moreover, they launched a misinformation campaign targeted at the property tax, framing it as the confiscation of small campesino housing and their landholdings. In turn, this resulted in peasant organisations organising widespread protests throughout the countryside against tax reforms that would have benefitted them most. When even the main opposition party, the '*Frente Republicano Guatemalteco*' (FRG), openly campaigned against the tax reforms, Arzú's government had to retract its property tax and refrain from making the corporate tax permanent.

### 2. *The Portillo Administration (2000-2003)*

By appealing to the poor and middle classes and pleading to reduce business influence over politics, the FRG's Alfonso Portillo won the presidential elections with over 48 per cent of the vote. Moreover, because his campaign had not been financed by CACIF but by new emerging industries, he was seen as very able to propose firm tax reforms. Learning from previous administrations, Portillo tried to engage civil society in constructing a 'Fiscal Pact'; essentially forcing CACIF and civil society members to propose and agree on tax reforms. Yet, from three possible taxes discussed on idle land, finance and VAT, the CACIF refused to discuss anything but the last. Civil society players were only willing to negotiate VAT increases if a number of corporate tax exemptions and privileges were eliminated. The CACIF refused and the talk's failure initiated rising doubts about Portillo's ability to initiate tax reforms.

As a result, Portillo decided to unilaterally push through the proposed VAT rise and corporate tax reform of the Fiscal Pact without civil society's support or approval (Sanchez, 2009).

The resistance initiated by CACIF was both widespread and comprehensive, by initiating a public campaign targeting the VAT rise, as this influenced all citizens, as a means to undermine the entire tax package. It presented itself as saviour of the average Guatemalan by creating the *Foro Guatemala*, a 'civil society' umbrella-organisation including trade unions and student organisations, to demonstrate against the 'fiscal terrorism' of the state. CACIF also led a national strike closing over 90 percent of Guatemala City's businesses, and filed 31 lawsuits against the new taxes on the basis of unconstitutionality. Portillo still pushed through its mild tax reforms, yet the political price paid meant prospects for future tax reforms were very low (Sanchez, 2009).

### 3. *The Berger Administration (2004-2007)*

With president Oscar Berger of '*Gran Alianza Nacional*' (GANA), Guatemala's government again turned pro-business, where nine out of 13 cabinet ministers were regarded as private sector representatives, as were six out of 11 state secretaries (Inforpress Centroamericana, 2005a). This loyalty to business interests placed the government in an awkward situation, as it also faced a significant fiscal crisis. While budgeted expenditures were Q30,000 million Guatemalan quetzales, predicted tax revenues were only Q19,000 million, leading to the threat of rising inflation, high interest rates and economic instability (Inforpress Centroamerica, 2004). Even though the GANA government initially tried to build support for fiscal reforms, it did not have the necessary independence from the private sector to propose any significant tax reform because it was staffed and financed directly by business sector representatives. Ultimately, Berger addressed the balance of payment problem by increasing foreign indebtedness (Inforpress Centroamericana, 2005b). Moreover, it *decreased* tax collection by providing tax exemptions to tobacco, beverage and mining companies and offered VAT refunds on business exports (Sanchez, 2009). Due to its close business ties, the Berger Administration managed to leave a revenue shortage of Q2500 million to subsequent governments, thus leaving Guatemala with an ever bigger fiscal challenge.

## VI. CONCLUSION

The history of tax reform for three Guatemalan administrations adequately describes not only the consistent ability of CACIF to bias fiscal policy to its own advantage; it also reflects the rich set of mechanisms it uses to prevent tax reforms. As reflected in this paper's theoretical framework, two methods are dominant to influence tax reform. Firstly, *campaign contributions* are critical. The success of

Portillo's limited reforms, in contrast to Arzú and especially Berger, can be put down largely to its limited ties to organised business, which meant it could initiate tax reforms despite very extensive protests. Secondly, *misinformation campaigns* were key for CACIF to extend its influence by organising other players to protest against reforms that would benefit them. This reflects Guatemala's sad reality; while organised business' financial contributions preserve their tax privileges, they could not have done so without the active campaigning of society's poorest.

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